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Omar Salah
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	Dr P. Ali
	Dr V. Mak

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before a committee appointed by the doctorate board
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Under the supervision of:	Professor R.D. Vriesendorp *Tilburg University (Tilburg Law School)* Professor R.M. Wibier *Tilburg University (Tilburg Law School)*
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Editorial Preface

In the Center for Company Law at Tilburg University, researchers investigate the functioning of business organisations from a business law and tax law perspective. The central focus point in their research is the question how to facilitate different types of entrepreneurial activities, while balancing between efficiency and fairness. Facilitating entrepreneurial activities requires an adequate and efficient legal infrastructure, in which company law, tax law, contract and property law as well as insolvency law take a prominent position. Financing business organisations and the legal infrastructure in which financial arrangements prosper is one of the main research themes of the Tilburg Center for Company Law.

The academic debate on finance until recently focused primarily on 'Western' legal systems, paying only little attention to financial arrangements and techniques to finance business organisation in other legal systems, notably in the Islamic legal tradition. Western jurisdictions are more and more confronted with financial arrangements that are based on principles stemming from Islamic Law, raising the question how these finance structures can be aligned with and fitted into, for example, the Dutch legal system. This may be problematic due to differences in legal approaches and legal culture. However, the study by Omar Salah on Islamic finance clearly demonstrates that this does not need to be the case, since he concludes that structures of Islamic finance portrayed in his study, are admissible under Dutch law. Vice versa, until now Islamic finance structures are often governed by English Law. This study shows that there are no serious legal impediments that Islamic finance contracts could be drafted under and governed by Dutch law.

The editors of the Center for Company Law Series highly recommend Omar Salah's innovative book '*Sukuh* Structures: Legal Engineering under Dutch Law' to our readers, academic scholars and practitioners alike.

Tilburg, March 2014

Peter Essers
Eric Kemmeren
Joe McCahery
Ger van der Sangen
Christoph Van der Elst
Erik Vermeulen

Preface

This book is on Islamic finance, in particular on *sukuk* (Islamic securities), under Dutch private law. It has been written in order to obtain a PhD at Tilburg Law School, Tilburg University. Researching and writing this dissertation not only allows me to become a Doctor of Philosophy, but it has also given me a better understanding of the significance of becoming a *Philosophiae Doctor* in its original Greek meaning: love of wisdom.

The journey towards this love of wisdom started off in the final year of my law studies when I was writing my master's thesis and working as a teaching and research assistant at the Property and Insolvency Law practice group of the Private Law Department. Professor Reinout Vriesendorp and Professor Reinout Wibier invited me to write a PhD proposal based on the subject of my master's thesis: Islamic finance law. Back then I could not wait to become a practising lawyer. However, during the process of writing my master's thesis I found both doing research and the topic of my master's thesis fascinating. So I combined doctoral research with practising law. During the first two years of my doctoral programme (October 2009-August 2011), I was a PhD candidate at Tilburg University, while being affiliated with De Brauw Blackstone Westbroek. In the following two and half years of my doctoral programme (September 2011-February 2014), I worked as a lawyer (*advocaat*) at De Brauw Blackstone Westbroek and worked on my dissertation mainly in the evenings (or to put it more accurately, late nights/early mornings) and weekends. This book could not have been written without the support of many people, only a few of whom I am able to mention in this preface. This does not mean that the support of those unmentioned is not equally appreciated.

I would first like to thank my supervisors Professor Reinout Vriesendorp and Professor Reinout Wibier. Their supervision and guidance has been crucial. Both supervisors have been able to inspire me, motivate me, and guide me in the best way possible. I am extremely grateful to both of them. Although I do acknowledge that the time frame for writing this book was completely self-imposed, both supervisors knew how to ensure that I did not lose sight of it. During the first two years of the process, Professor Reinout Wibier used to ask me on a daily basis: "*Is het boek al af*? ("Is the book finished yet?"). He even made sure to remind me of this while he was visiting me in London in the summer of 2010 during my secondment with King & Spalding. After two

years, I continued my career at De Brauw Blackstone Westbroek. Within a few months, Professor Reinout Vriesendorp sent me a text message from a conference in Italy to announce that he would be joining De Brauw Blackstone Westbroek as well. In those subsequent two and half years, he reminded me almost on a daily basis what a relief it would be for me when I handed in my dissertation so that I could focus on my career as a lawyer. After having attended his lectures on property and insolvency law from the very first years of my law degree onwards, having worked with him as a teaching and research assistant as a young student, and writing a dissertation under his supervision, it was an honour to learn the very first skills as lawyer from him as well.

In this preface I also would like to make a confession. Although my official PhD programme was planned for 5 years combined with practising law, according to my hidden agenda I had to write my dissertation in 2 years and join De Brauw Blackstone Westbroek afterwards. However, being too eager also has its downsides. As if writing a dissertation in two years was not ambitious enough, I was determined to experience the life of an academic at Tilburg University to the fullest. So I decided to give lectures at Tilburg University and guest lectures at Maastricht University and Leiden University, spend some time abroad as one would expect from a true academic in the field of international finance law, and speak at international conferences and publish extensively. Not surprisingly, I failed to submit my dissertation after those two years but my growth as an academic and as a person made sure that I did not regret that for a single moment.

I would like to thank my colleagues at Tilburg University who directly or indirectly contributed to my dissertation. I thank Professor Theo Raaijmakers, Professor Eric Tjon Tjin Tai, Professor Bert van Schaick, Professors Maurits Barendrecht and Dr Gijs van Dijck for their involvement. I thank Dr Vanessa Mak, who I used to share an office with, for the valuable discussions. I would like to thank Professor Jan Vranken in particular for motivating me to start working on a PhD in the first place and for his continued involvement afterwards. The unexpected and unannounced meetings and discussions with Professor Herman Schoordijk were inspirational and it is an honour to publish my dissertation in the Schoordijk Instituut Series which is named after him. I also would like to thank Tilburg Graduate Law School for teaching me how to conduct proper legal research. In addition, I thank the European Banking Center, in particular Professor Thorsten Beck, Professor Steven Onega and Professor Sylvester Eijffinger, for their involvement and discussions on the subject. Finally, I thank Ineke Sijtsma, former English editor at Tilburg University, for her comments on very early drafts of the dissertation.

In 2010, I worked as a Visiting Researcher at the University of Oxford thanks to Dr Vanessa Mak and Professor Stefan Vogenauer who welcomed me at the Institute of European and Comparative Law at the University of Oxford. I would like to thank Professor Louise Gullifer and Professor John Cartwright for the insightful discussions. In 2011, I worked as a Visiting Researcher at the University of Melbourne thanks to Professor Reinout Vriesendorp and Professor Ian Ramsay. I am grateful to Professor Abdullah Saeed for welcoming me as a Visiting Researcher at the National Centre of Excellence for Islamic Studies Australia at the University of Melbourne and for sharing his views on the subject of my dissertation. I also would like to thank Dr Paul Ali for the interesting discussions on international finance law. While being in Melbourne, I was invited by Dr Ishaq Bhatti to teach an Islamic Finance Professional Development Course on Islamic Finance at La Trobe University, who I would like to thank for his warm welcome and hospitality. Finally, I thank the Australia-Netherlands Research Collaboration which made the academic visit to Melbourne possible by granting me the PhD Overseas Travel Fellowship for the Australia-Netherlands Research Collaboration.

I thank Professor Abdullah Saeed and Professor Mohamed Ariff who invited me to speak at the 'Foundation of Islamic Finance Series Conferences' in Kuala Lumpur, Malaysia in 2011. I thank Professor Saadiah Mohamad from the Universiti Teknologi MARA (UiTM) for the discussions on Islamic finance and for her hospitality while I was in Malaysia. I also would like to thank Professor René Smits who invited me to speak at a seminar on 'Legal Risks and Good Governance for Central Banks' at the University of Cambridge in 2012 and for inspiring me from the very first day we met in The Hague. Furthermore, I thank Professor Jan Biemans (who I met as a colleague at De Brauw Blackstone Westbroek) for his support with regard to my dissertation.

In 2010, I was also on a secondment at the Middle East & Islamic Finance practice group of law firm King & Spalding in London. It was a pleasure to work alongside the lawyers of this firm who have great expertise in Islamic finance. I would like to thank Isam Salah, Jawad Ali and Mike Rainey for welcoming me to the firm. I would like to thank Kevin Conway, John Clay Taylor, Elizabeth Lyon and Asal Saghari for their hospitality and all the interesting matters we worked on during my secondment.

A special word of thanks goes to my law firm De Brauw Blackstone Westbroek for making this dissertation possible and for its continuous and unconditional support throughout the process. There are a few people who I would like to mention in particular. Sjoerd Eisma, Berend Crans, Niek Biegman and Ernest Meyer Swantée showed their support and involvement at an early stage and,

among other things, made the secondment with King & Spalding possible. Thanks goes to Marc Ynzonides (who has been my PhD mentor inside the firm) and Kees Peijster (who is my supervising principal (*patroon*)) for supporting me since the day I joined the firm as a lawyer. I would like to thank Ruud Hermans and Berto Winters not only for their support with regard to my dissertation while I was with the Litigation and Arbitration practice group of the firm, but also for teaching me how to become a litigator. I am very grateful to Professor Martin van Olffen for his discussions on the corporate law aspects of my dissertation and for his comments on earlier drafts. I also thank Professor Harm-Jan de Kluiver for the discussions on the corporate law aspects of my dissertation. Furthermore, I would like to thank Stephen Machon, English editor at De Brauw Blackstone Westbroek, for his comments on my dissertation. Finally, I would like to thank the staff at the Business Support of De Brauw Blackstone Westbroek.

My master's thesis which I defended on 29 September 2009 titled "Islamic Finance: Structuring *Sukuk* in the Netherlands" was a preamble to this book. It was awarded the Harry Honée Master's Thesis Award 2008/2009. My master's thesis was also awarded the RIMO Master's Thesis Award 2009/2010. I would like to thank Stichting Harry Honée Fonds and Vereniging RIMO for acknowledging my work back then and I hope that I can live up to any expectations raised after that with my dissertation.

I thank the members of my PhD Committee, Emeritus Professor Hans Visser, Professor Louise Gullifer, Professor Rieme-Jan Tjittes, Dr Paul Ali and Dr Vanessa Mak for reviewing my dissertation. I also thank Eleven International Publishing, part of *Boom juridische uitgevers*, for publishing my dissertation.

Most importantly, I would like to thank my family and close ones for their ongoing love, support, and understanding. The love, care, and guidance of my parents, Salahuddin Salah and Mashaal Salah-Najib, and my siblings, Khibar Salah, Lemar Salah, Lema Salah, and Maiwand Salah, are with me with at every step in life. To them I owe every achievement in life. I also would like to thank Nathalie Bruyn for her unconditional love and I hope that I will always be able to stand as firmly beside her as she has beside me.

I dedicate this book to my parents who taught me the true meaning of love, wisdom, and the love of wisdom.

Amsterdam/Tilburg, March 2014

Contents

List of Abbreviations

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
AAOIFI SS	AAOIFI *Shari'ah* Standard
AAOIFI SS 8	AAOIFI SS No. 8 on *Murabaha* to the Purchase Orderer
AAOIFI SS 9	AAOIFI SS No. 9 on *Ijarah* and *Ijarah Muntahia Bittamleek*
AAOIFI SS 10	AAOIFI SS No. 10 on *Salam* and Parallel *Salam*
AAOIFI SS 11	AAOIFI SS No. 11 on *Istisna'a* and Parallel *Istisna'a*
AAOIFI SS 12	AAOIFI SS No. 12 on *Sharika* (*Musharaka*) and Modern Corporations
AAOIFI SS 13	AAOIFI SS No. 13 on *Mudaraba*
AAOIFI SS 17	AAOIFI SS No. 17 on Investment *Sukuk*
AAOIFI SS 21	AAOIFI SS No. 21 on Financial Paper (Shares and Bonds)
BV	*Besloten vennootschap*
DBA	Dutch Bankruptcy Act (*Faillissementswet*)
DCC	Dutch Civil Code (*Burgerlijk Wetboek*)
DIFC	Dubai International Financial Centre
EURIBOR	Euro Interbank Offered Rate
GCC	Gulf Cooperation Council
IHPIPA	Interim Hire Purchase Immovable Property Act (*Tijdelijke wet huurkoop onroerende zaken*)
IIBR	Islamic Interbank Benchmark Rate
LIBOR	London Interbank Offered Rate
NJ	*Nederlandse Jurisprudentie*
NV	*Naamloze vennootschap*
OIC	Organization of the Islamic Conference
RI	*Rechtspraak Insolventierecht*
RvdW	*Rechtspraak van de Week*
SPV	Special purpose vehicle
W	*Weekblad van het Recht*

1 Introduction

1.1 Introduction to the Subject of the Study

Islamic finance gained much interest in both academia and practice in the first decade of the 21st century. In this study the possibilities for a specific Islamic finance product, *sukuk*, will be explored under Dutch private law.

1.1.1 Islamic Finance

Islamic finance as known today is a product of the 20th century. However, the practice of Islamic finance dates back to medieval times. Islamic finance contracts such as *musharaka* and *mudarabah* were discussed in detail by early scholars, such as Ibn Rushd, also known as Averroes.[1] The centuries-old practice of Islamic finance fell into disuse during the period of European colonial empires.[2] Modern-day Islamic finance arose after the independence of Muslim countries in the second half of the 20th century. Certainly, the renaissance of Islamic finance occurred in the Islamic world. It would, however, be inaccurate to reach the conclusion that Islamic finance is only a product of Islamic jurisdictions. The United States of America and Europe, the United Kingdom in particular, have contributed extensively to the growth of the Islamic finance industry. As a result, Islamic finance is not an exotic form of finance but is part of a range of finance schemes in the international world of finance.

As a starting point, Islamic finance is similar to conventional finance. However, in addition to financial, accounting and tax considerations, Islamic finance has to meet the rules of Islamic law, the *Shari'ah*.[3] In essence, all Islamic finance transactions should meet three Islamic law requirements: (i) the transactions cannot relate to *haram* activities (activities that are regarded

1 Abu al-Walid Muhammad ibn Ahmad ibn Rushd (1126-1198) or in short Ibn Rushd – in the Medieval West known as Averroes – was a well-known judge (*qadi*), but also a philosopher and a physician. He was a master in law and jurisprudence, theology, philosophy, mathematics and the sciences of medicine. Ibn Rushd is regarded as one of the most important Islamic philosophers. For his work on Islamic finance contracts, *see* Ibn Rushd (Nyazee) 1996.

2 Vogel & Hayes 1998, pp. 4-5.

3 In this study, the terms 'Islamic law' and '*Shari'ah*' are used as synonyms of each other. Another term used in the literature is 'Islamic *Shari'ah*' to stress that reference is made to Islamic law and not to any (other) law or set of rules. In this book the word '*Shari'ah*' will always refer to Islamic law.

immoral); (ii) the receipt and payment of *riba* (in short: interest) is forbidden and (iii) *gharar* (contractual uncertainty) should be avoided as much as possible. On the basis of these three Islamic finance principles, several Islamic finance contracts and Islamic finance products are structured. One such product is *sukuk*.[4]

1.1.2 *Sukuk*

Sukuk are one of the most well-known Islamic finance products. *Sukuk* are Islamic securities. Conventional shares are regarded as *Shari'ah*-compliant financial instruments within Islamic finance law. However, conventional bonds are not *Shari'ah*-compliant mainly due to the payment of interest to bond holders. Furthermore, as a result of the prohibition of *riba*, the trade in debt claims is also prohibited under Islamic finance law. When bond holders trade conventional bonds in secondary markets, they trade in debt claims, which results in a violation of the ban on *riba*. As an answer to the need for a *Shari'ah*-compliant alternative to conventional bonds, *sukuk* entered the capital markets. This also explains the extensive use of the term 'Islamic bonds' when addressing *sukuk*.

The term 'Islamic bond' may, however, be misleading because *sukuk* differ from conventional bonds. The main differences between *sukuk* and conventional bonds are: (i) a *sukuk* transaction cannot contain the payment of interest; and (ii) *sukuk* holders must hold some degree of ownership in the underlying property of the *sukuk* transaction. Islamic finance contracts are used to generate profit in a *sukuk* transaction: revenues are realised through the use of partnerships (as a result of which the returns are not fixed, contrary to the payment of interest) or through the trade in tangible property (whereby money is not traded with money, contrary to the payment of interest). The profits realised are paid to *sukuk* holders as the periodical payments over the *sukuk*, instead of interest as is the case with conventional bonds. Furthermore, the *sukuk* holders hold some degree of ownership in the underlying tangible property of the *sukuk* transaction according to Islamic finance rules. Consequently, while trading *sukuk* in secondary markets, they are deemed to be trading in the underlying tangible property, instead of (merely) trading in debt claims.

4 The word '*sukuk*' is the plural of the Arabic word '*sakk*', which means (financial) certificate. In Islamic finance literature the word '*sukuk*' is used as an irregular noun, the singular and plural of which are identical.

1.2 Purpose and Relevance of the Study

The purpose of this study is to analyse the legal aspects of *sukuk* structures under Dutch private law. From a practical perspective, this study provides Dutch legal practice insight into the possibilities to issue *sukuk* under Dutch law. The *sukuk* market is showing an incredible growth. The Netherlands has not entered the *sukuk* market yet. A *sukuk* issuance under Dutch law might offer participants in the Dutch banking and finance practice opportunities to attract funding from a pool of investors, which is rather new to the Dutch banking and finance practice. From an academic perspective, this study provides an in-depth analysis of the legal structure of *sukuk* and its interaction with Dutch private law. Not only does this research illustrate how these two can interact, but studying the interaction of an Islamic finance instrument and Dutch law might also lead to a better understanding of the Islamic legal system and the Dutch legal system.

1.2.1 Growth of the Islamic Finance Industry and *Sukuk* Market

1.2.1.1 Islamic Finance Industry

The growth of the Islamic finance industry has been remarkable. The 1970s are generally taken as the starting point of the current Islamic finance market. In the last 40 years, the Islamic finance market has grown to a trillion-US-dollar industry. In 2012, the actual global size of the Islamic finance industry was estimated to be USD 1.631 trillion, with an annual growth rate of 20.2% compared to 2011.[5] One should not overlook the fact that it concerns a growth in times of economic turmoil. As appears from the growth figures, the Islamic finance industry was not directly affected by the financial crisis of 2007.[6] It would, however, be naïve to expect that the Islamic finance industry was completely unaffected by a financial crisis as witnessed in 2007.[7]

> It has also been argued that the use of Islamic finance could have avoided the financial crisis. The question to the exact impact of Islamic finance on the financial crisis is not dealt with in this study. Nonetheless, the question does illustrate

5 Global Islamic Finance Report 2013, p. 35.
6 Global Islamic Finance Report 2011, p. 34.
7 The impact of the financial crisis of 2007 was felt throughout the world. So it was in Islamic countries and so it was in the Islamic finance market. For example, as a result of the financial crisis, a *sukuk* issued by real estate developer Nakheel had to be restructured, which caused disturbance in capital markets referred to as the 'Dubai debt crisis'. For more on the Dubai debt crisis and the legal structure of the Nakheel *sukuk*, *see* Salah 2010b.

the relevance of and the interest for Islamic finance both from an academic and societal perspective.[8]

In recent years, several European jurisdictions entered the Islamic finance market. The United Kingdom has made amendments to its laws since 2003 to promote Islamic finance. As a result, London has taken a leading position in the world of Islamic finance. France proposed amendments to its laws to make the issuance of *sukuk* possible. Luxembourg is amending its tax laws and promoting the possibilities for Islamic finance products. Germany took a head start with the first Western *sukuk* issuance in 2004. The first Islamic private bank, the Faisal bank, was incorporated in 2006 in Switzerland. The Netherlands is, however, lagging behind these developments in the financial markets.

1.2.1.2 Sukuk Market

Within the Islamic finance market, the market for *sukuk* has been promising. The value of global aggregate *sukuk* for the period of January 1996 to September 2012 is estimated to be USD 396.4 billion.[9] The *sukuk* market was at its most active between 2010 and 2012.[10] In 2012, global *sukuk* issuance reached a record USD 144 billion.[11] Initially, most *sukuk* were issued by (semi-) governmental entities (referred to as sovereign issues). By 2008, however, 56% of all *sukuk* were issued by corporate entities (referred to as corporate issues).[12] In 2012, the number of corporate issues was still higher than the number of sovereign issues, but sovereign issues held an estimated 54% market share of amount issued.[13]

From a geographical perspective, Malaysia has taken the lead in the *sukuk* market, followed by the GCC countries, the United Arab Emirates in particular. Another important player is the United Kingdom. By September 2012, 42 *sukuk* were listed on the London Stock Exchange, raising a total amount of USD 27 billion through *sukuk* issuance.[14] The United Kingdom unveiled its plans to issue its first *sukuk* in 2014.[15] In addition, there have also been some *sukuk* issues in other Western countries. The first *sukuk* issued in Europe

8 For more on the impact of Islamic finance on the credit crunch and vice versa, *see* Wibier & Salah (*Islamic Finance and the Influence of Religion on the Law)* 2011, with further references to the literature.
9 Thomson Reuters Zawya Sukuk Perceptions and Forecast Study 2013, p. 58.
10 *Ibid*., p. 8.
11 Global Islamic Finance Report 2013, p. 38.
12 Global Islamic Finance Report 2011, p. 69. The percentage of 56 corporate issues corresponds with the estimations of the IIFM *Sukuk* Report on 30 June 2009, *see* IIFM *Sukuk* Report 2010, p. 16.
13 Thomson Reuters Zawya Sukuk Perceptions and Forecast Study 2013, p. 64.
14 *Ibid*., p. 69.
15 Watt, *The Guardian*, 29 October 2013.

was the Saxony-Anhalt *Sukuk* which was issued by the German state Saxony-Anhalt in 2004. In the United States of America, several *sukuk* have been issued so far, for example, a *sukuk* issued by General Electric in 2009.[16]

1.2.2 The Practice of Islamic Finance and the Netherlands

Historically, Dutch banks have contributed to the practice of Islamic finance. At the beginning of the twentieth century, the Netherlands Trading Society (*Nederlandsche Handel-Maatschappij*) was allowed to establish itself in Jeddah, Saudi Arabia, to provide interest-free money-exchange services to pilgrims from Dutch Indonesia.[17] The Netherlands Trading Society was one of the predecessors of ABN AMRO. In 1977, ABN AMRO established the Saudi Hollandi Bank.[18] Today, the Saudi Hollandi Bank is active in the field of Islamic finance with, for example, a *sukuk* issuance in 2009 in the Kingdom of Saudi Arabia.[19]

In recent years, Dutch banks such as ING and ABN AMRO have offered Islamic finance products. These products were not offered in the Netherlands, but they were offered in Southeast Asia, in Malaysia in particular.[20] In 2010, ABN AMRO moved its Middle East operations to the DIFC. Due to the importance of Islamic finance in this region, ABN AMRO was considering offering Islamic finance retail products in the United Arab Emirates. The activities discussed illustrate that Dutch banks have been active in the Islamic finance market outside the Netherlands.

When discussing the Islamic finance market in the Netherlands, a distinction should be made between the retail banking market and the investment banking market. Most of the discussions with regard to Islamic finance in the Netherlands have been focused on the retail banking market so far. Rabobank studied the potential demand for Islamic banking among households in the Netherlands. A study of the Dutch Central Bank (*De Nederlandsche Bank*) and of the Dutch financial services regulatory authority (*Autoriteit Financiële Markten*) on, *inter alia*, Islamic finance mortgages showed that there is a demand for Islamic finance in the Netherlands due to the growing Muslim

16 For more on the legal structure of the *sukuk* issued by General Electric, *see* Rainey & Salah 2011, pp. 113-131.
17 Islamic Finance in Europe 2007, p. 2.
18 Saudi Hollandi Bank was established as a joint stock company by ABN AMRO. ABN AMRO is still holding 40% of the shares of Saudi Hollandi Bank. The remaining 60% of the shares are held by Saudi nationals. *See* Saudi Hollandi Bank, Annual Report 2012, pp. 8 & 71.
19 For a description of the structure of the *sukuk* issued by Saudi Hollandi Bank, *see* Salah 2010c, pp. 507-517.
20 Islamic Banking and Finance: Insight on Possibilities for Europe 2009, p. 40.

population.[21] Several tax impediments, however, obstructed the emergence of an Islamic retail banking market in the Netherlands.[22]

The investment banking side has not received serious thought in the Netherlands yet. To a modest extent, there have been some activities on the Islamic investment banking side in the Netherlands: ABN AMRO and the Liechtensteinische Landesbank launched a structured investment product called LLB Top 20 Middle East Total Return Index Certificate in 2007 and Barclays launched three Amsterdam-listed Islamic investment products in 2008.[23] However, there have not been any other activities on the investment banking side yet. Most Dutch entities are unfamiliar with the Islamic investment banking market. Nonetheless, there seems to be a demand for Islamic finance in the Netherlands.[24] In addition, Islamic finance products might be an attractive instrument to attract funding from Islamic jurisdictions. In 2009, Saudi Arabia expressed its intention to invest billions in the Netherlands.[25] *Sukuk* is a financial instrument that could attract or facilitate such funding.

In the Netherlands there has not been a *sukuk* issuance by a Dutch entity yet. The issuer of the German Saxony-Anhalt *Sukuk* mentioned above was a Dutch foundation (*stichting*) in 2004. The entire structure was, however, initiated by the German state Saxony-Anhalt. Hence, the issuance is regarded as a German issuance. An interesting question is whether a Dutch governmental or corporate entity could raise money through the issuance of *sukuk* under Dutch law. To date, there has not been a study that deals with the possibilities for *sukuk* under Dutch law.[26]

1.2.3 Islamic Finance in the World of Academia

The practice of Islamic finance dates from medieval times and so do the very first studies dealing with Islamic finance contracts.[27] With the emergence of Islamic finance in the second half of the 20th century, most of the work initially focused on Islamic economics and the concept of *riba* and *zakat* (a form

21 DNB Report (Islamic Finance and Supervision: An Exploratory Analysis) 2008, pp. 21-24.
22 For more on these tax issues under Dutch law, *see* Sinke 2007; Kranenborg & Talal 2007, pp. 1259-1267; Hooft & Muller 2008, pp. 624-632; Kranenborg & Sinke 2009a, pp. 770-779; Kranenborg & Sinke 2009b, pp. 5-13.
23 DNB Report (Islamic Finance and Supervision: An Exploratory Analysis) 2008, p. 24.
24 *Ibid*., pp. 21-24.
25 Daling, *Het Financieele Dagblad*, 6 October 2009.
26 The only study that deals with this question is Salah 2010a, which can be regarded as a preamble to this work.
27 Ibn Rushd, for example, discussed Islamic finance contracts in the 12th century, see Ibn Rushd (Nyazee) 1996. His work contains a compilation of the different schools of Islamic law, denoting that much was written on these contracts by Islamic scholars before his time.

of alms).[28] Islamic banking gained attention as a branch of Islamic economics. With the exception of some early works,[29] most of the studies dealing with Islamic finance started to appear from the 1990s onwards. Certainly, Islamic finance is still a relatively new subject in the world of academia. Nonetheless, much has been written on the subject in the last 20 years.[30]

From an academic perspective, the focus of most of the studies has been on *Shari'ah*-related issues and on Islamic economic theories. In addition, several works appeared on the practice of Islamic finance in recent years.[31] Although Islamic jurisprudence is discussed extensively in the literature, not much has been written on the legal aspects of Islamic finance, that is, on the interaction of Islamic finance with the law of a jurisdiction that governs the Islamic finance contracts. Only some authors have contributed to the legal aspects of Islamic finance.[32] Even more peculiar are studies dealing with *sukuk*. Even though the *sukuk* market's incredible growth is proof of much activity in practice, not much has been written on *sukuk* in the literature.[33] In the Dutch literature several studies have appeared on Islamic finance.[34] The developments in the Netherlands are dissimilar to the developments in the rest of the world: Islamic finance has gained attention in academia, while it has not taken off in practice yet.

The focus of this study is on the legal structure of *sukuk* under Dutch law. Three aspects of Islamic finance that have not gained much attention in the literature are discussed: (i) the legal aspects of Islamic finance; (ii) *sukuk*; and (iii) the possibilities for *sukuk* under Dutch law. There seems to be an opportunity to contribute to the world of academia at the intersection of these three aspects because all three aspects have been underexposed in the literature.

28 *See* Rahman 1942; Ahmad 1947; Al-Sadr 1961; Mannan 1970; Udovitch 1970; Nur 1978; Mawdudi 1979; Siddiqi 1981.

29 One of the most notably early works in the field of Islamic finance is Aghnides 1916. Another early study is Uzair 1955.

30 For some of the most important works in the field of modern-day Islamic finance, *see* Saleh 1986; Saeed 1996; Vogel & Hayes 1998; Usmani 2002; El-Gamal 2006; Ayub 2007.

31 For some examples, *see* Thomas, Cox & Kraty 2005; Iqbal & Mirakhor 2006; Archer & Karim 2007; Hassan & Lewis 2007; Ali 2008.

32 For one of the few studies dealing with Islamic finance from a legal perspective, *see* Thani, Abdullah & Hassan 2003. Furthermore, some papers have been written on the legal aspects of Islamic finance, *see* McMillen 2007; McMillen 2008; Salah 2010b; Salah 2010c; Salah 2011c; Salah 2012.

33 There have been several papers on *sukuk* in literature, but an entire study on the subject is rather exceptional. The few complete studies on *sukuk* are Adam & Thomas 2004; Ariff, Iqbal & Mohamad 2012.

34 Sinke 2007; Kranenborg & Talal 2007, pp. 1259-1267; Hooft & Muller 2008, pp. 624-632; Tjittes 2008, pp. 136-144; El-Idrissi 2008, pp. 39-42; Vine *et al.* 2008, pp. 414-423; Kranenborg & Sinke 2009a, pp. 770-779; Kranenborg & Sinke 2009b, pp. 5-13; Salah 2010a; Salah 2010d, pp. 271-272; Salah 2010e, pp. 629-638; Wibier & Salah 2010, pp. 1738-1746; Salah 2011a; Salah 2011b, pp. 148-158.

1.3 Research Question and Theoretical Framework

The research question of this study is

> *How can* sukuk *transactions be structured under Dutch private law and what Islamic and Dutch legal issues arise when structuring* sukuk *under Dutch private law?*

Before being able to answer this question, some sub-questions need to be answered. The following sub-questions are dealt with in this study:

1. *What is Islamic law and in what way does it contribute to Islamic finance?*
2. *In what way have Islamic finance principles such as* riba *and* gharar *had an influence on Islamic finance contracts?*
3. *What are the Islamic finance rules for Islamic finance contracts?*
4. *What are the Islamic finance rules for* sukuk *and how are* sukuk *structures legally structured?*
5. *How is the ownership of the underlying property in a* sukuk *transaction transferred to* sukuk *holders under Islamic finance law?*
6. *How can* sukuk *structures be structured under Dutch property, contract, corporate and bankruptcy law?*
7. *In what way can the Islamic finance requirement that the ownership of the underlying property in a* sukuk *transaction should be transferred to* sukuk *holders be met under Dutch property law?*

Islamic finance is based on Islamic law. The first sub-question deals with Islamic law and Islamic jurisprudence. After discussing Islamic law, I will elaborate on Islamic finance principles such as *riba* and *gharar*. These principles impact the rules of Islamic private law, that is, Islamic property and contract law. Within Islamic finance, nominate Islamic finance contracts are used. Islamic finance principles (such as *riba* and *gharar*) and the rules of Islamic private law determine the rules applicable to Islamic finance contracts (sub-questions 2 and 3).

The Islamic finance contracts are, in turn, used to structure *sukuk*. Sub-question 4 deals with the legal structure of *sukuk* transactions and the Islamic finance rules that should be taken into consideration while structuring *sukuk*. I will discuss the legal structure of different types of *sukuk*. Before being able to assess *sukuk* structures under Dutch law, I will also assess how the ownership of the underlying property in a *sukuk* transaction is transferred to *sukuk* holders under Islamic finance law (sub-question 5).

Finally, I will assess the *sukuk* structures discussed in this study under Dutch law (sub-questions 6 and 7). I will assess whether, and if so how, the Islamic finance rules for *sukuk* can be respected under Dutch property,

contract, corporate and bankruptcy law (sub-question 6). I will in particular focus on whether, and if so how, the Islamic finance requirement that the ownership of the underlying property in a *sukuk* transaction should be transferred to *sukuk* holders can be met under Dutch property law (sub-question 7). It should be noted that my assessment under Dutch law is limited to Dutch private law. Dutch private law aspects are discussed with a main focus on property, contract, bankruptcy and corporate law. Dutch tax law is not dealt with in this study.[35] Regulatory issues and private international law are not discussed either in this study.

I acknowledge that private international law issues may arise in legal practice while structuring *sukuk*, *sukuk* being an international financial instrument. I also acknowledge that in practice *sukuk* documentation is often governed by English law. In this study, however, I would like to explore the possibilities for *sukuk* under Dutch law. Therefore, the starting point of each *sukuk* structure is the hypothetical situation where a Dutch legal entity initiates a *sukuk* transaction through the use of underlying property located in the Netherlands, in which all transaction documents are governed by Dutch law.

1.4 Methods of Research

Before being able to assess *sukuk* under Dutch law, the Islamic basis for *sukuk* and its implementation in practice should be discussed. With regard to the Islamic basis for *sukuk*, I have mainly studied secondary sources on Islamic law and on the development of Islamic jurisprudence. Most of the original sources are in the Arabic language and due to a language barrier, English translations of these sources have been studied. In addition, being a Netherlands trained lawyer I lack the qualifications to interpret the original sources as a religious scholar. Therefore, reference to the religious texts has been kept to a minimum.

In this study I have discussed the Islamic requirements for Islamic finance as legal rules. Where 'translation' of the religious requirements into legal rules was required, I have made a modest attempt to do so. I, however, do not claim to have the religious qualifications to answer religious questions. After having made a 'translation' of the religious requirements into legal rules, I have treated Islamic law as a system of rules. While doing this, I have focused

35 Dutch tax law has an economic approach towards finance transactions (whereby the economic substance of a transaction prevails over its formal legal structure). Therefore, Dutch tax law does not seem to raise major issues while structuring *sukuk* in the Netherlands. For more on the tax law aspects of *sukuk* under Dutch law, *see* Rozendal & Westhoff (*Islamitisch bankieren: Van religieuze principes naar financiële transactiestructuren*) 2011; Muller (*Islamitisch bankieren: Van religieuze principes naar financiële transactiestructuren*) 2011.

on Islamic jurisprudence with regard to Islamic property, contract, corporate and finance law.

Where reference is made to the practice of *sukuk* structures, such reference is based on an analysis of prospectuses and offering circulars of *sukuk*. The selection of these documents is based on: (i) the type of *sukuk* structure; and (ii) the geographical location of the entity that initiated the *sukuk* issuance. As far as (i) is concerned, there are different types of *sukuk* structures. For the purposes of this book, the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah* have been assessed. In practice, the *sukuk al-murabaha* has been used least so far.[36] Furthermore, offering circulars of the *sukuk al-murabaha* are usually not publicly available, since such *sukuk* are often private placements.[37] Therefore, I have not been able to include offering circulars of the *sukuk al-murabaha* while referring to the practice of *sukuk*. The offering circulars studied in this book are those of the *sukuk al-ijarah* and the *sukuk al-musharaka*. The offering circulars of both types of *sukuk* have been included in this study to provide a representative understanding of the practice of *sukuk*. As far as the geographical location of the entity that initiated the *sukuk* issuance is concerned as referred to under (ii), the country of issuance may have impact on the structure of the *sukuk* issued. The religious texts have been interpreted differently by Islamic scholars in different countries. The most notable differences in the interpretation of the religious texts are between the Islamic scholars located in Malaysia and the Islamic scholars located in the Middle East. Therefore, offering circulars from both regions have been analysed in this book in order to ensure that possible deviations in interpretations are included while addressing the practice of *sukuk*.

A dogmatic legal approach is used for the largest part of this study. The focus of this study is on the possibilities of *sukuk* under Dutch private law. While analysing the possibilities for *sukuk* under Dutch law, a dogmatic legal method is used to conduct legal research: Dutch codes, case law, legislative history and other sources of law have been studied.

36 IIFM Sukuk Report 2010, p. 25. Some examples are the *sukuk al-murabaha* issued by Arcapita Bank and the *sukuk al-murabaha* issued by the Saudi Bin Ladin Group in 2010. For more on the Arcapita Bank *sukuk al-murabaha*, *see* Ayub 2007, pp. 405-406; Clifford Chance DIFC Sukuk Guidebook 2009, p. 46. For more on the Saudi Bin Ladin Group *sukuk al-murabaha*, *see* Carey, *Bloomberg*, 17 July 2010; AMEinfo, *AMEinfo.com*, 17 July 2010; Arab News, *ArabNews.com*, 17 July 2010. The publicly available information and literature do not provide much information about the details and the underlying transactions of the issued *sukuk al-murabaha*, *see* Ayub 2005, p. 362.

37 In case of the Saudi Bin Ladin Group *sukuk al-murabaha*, for example, it was a private placement to Saudi investors, *see* Carey, *Bloomberg*, 17 July 2010.

1.5 Organisation of this Book

In order to understand Islamic finance and Islamic finance products, it is essential to have a basic understanding of Islamic law. Therefore, the next chapter (Chapter 2) deals with Islamic law, its main sources and the development of Islamic jurisprudence. In that chapter, I will discuss how the two most important Islamic finance principles (*riba* and *gharar*) were developed in Islamic jurisprudence and how these principles have formed Islamic private law: these principles provide the religious requirements upon which Islamic private law was drawn by Islamic scholars.

The most important Islamic finance contracts will be discussed in Chapter 3. *Riba* and *gharar* and the rules of Islamic private law determine the rules applicable to Islamic finance contracts. I will describe the Islamic finance rules applicable to these contracts. The Islamic finance contracts discussed in Chapter 3 are used to structure *sukuk*. Hence, discussing the applicable *Shari'ah* rules for these contracts also determines the framework for *sukuk*.

In Chapter 4, different *sukuk* structures will be addressed. The chapter commences with a description of the history of *sukuk*. Next, the main characteristics of *sukuk* and its *Shari'ah* framework will be analysed. In this chapter I will describe how the ownership of the underlying property in a *sukuk* transaction is transferred to *sukuk* holders under Islamic finance law. The legal structures of the three most important *sukuk* transactions (the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah*) are outlined. By formulating the Islamic finance rules applicable to each structure, I will create a theoretical framework for the legal structure of the three *sukuk* transactions discussed in this chapter.

In the following chapter, Chapter 5, the main body of each *sukuk* structure is dealt with separately under Dutch law. *Sukuk* are issued by the application of the Islamic finance contracts discussed in Chapter 3 (such as the contracts of *musharaka*, *murabaha* or *ijarah*, which lead to the qualification of the structure as *sukuk al-musharaka*, *sukuk al-murabaha* or *sukuk al-ijarah*). In this chapter, I will also assess the application of those Islamic finance contracts in each *sukuk* structure under Dutch law. With regard to the *sukuk al-musharaka*, I will assess the incorporation of a *musharaka* stock company under Dutch corporate law. With regard to the *sukuk al-murabaha* and the *sukuk al-ijarah*, I will assess the contract of *murabaha* respectively the contract of *ijarah* as used in the *sukuk al-murabaha* respectively the *sukuk al-ijarah* under Dutch contract law and Dutch property law.

In Chapter 6, I will discuss the rights of the *sukuk* holders. I will assess in what way the *sukuk* holders acquire the ownership of the underlying property in each of the three addressed *sukuk* structures under Dutch property law. In this chapter, I will also assess the rights of the *sukuk* holders in each addressed

sukuk structure under Dutch bankruptcy law. In closing, a summary and the conclusions of this study will be presented in Chapter 7.

2 Islamic Law

In this chapter I discuss the development of Islamic law. I will elaborate on what Islamic law is and how Islamic legal rules are formulated by *Shari'ah* scholars. This occurs through Islamic jurisprudence. Within Islamic jurisprudence, two principles of Islamic finance have been formulated and developed further: *riba* and *gharar*. These two Islamic finance principles form the backbone of Islamic finance. On the basis of these principles, *Shari'ah* scholars have formulated the specific rules of, what I would like to call, Islamic private law. The Islamic finance principles and the rules of Islamic private law determine the structure of Islamic finance contracts, which, in turn, are used to structure *sukuk*.

2.1 Islamic Law and Jurisprudence

Islamic law within the meaning of Islamic finance is not codified law; it does not refer to the black-letter law of any jurisdiction. It refers to a set of rules that derived from religious texts. Islamic law and *Shari'ah* are often used as synonyms. From an Islamic perspective, law is regarded to be the command of God and the function of Islamic jurisprudence is to discover and formulate the terms of that divine command.[38] *Shari'ah* means 'the way' or 'the path to the water source', since it leads mankind to the essence of life.[39] The *Shari'ah* has been defined as a guide to ethics, but it might be more appropriate to refer to it as the canon law of Islam.[40]

> Islamic law is codified in the legislation of certain jurisdictions, either through incorporation in their acts or as a source of law upon which courts can base their rulings. In these jurisdictions, Islamic law is codified in black-letter law. As a result of such codification, the national legal system of that specific jurisdiction is influenced by Islamic law and vice versa. In the context of Islamic finance, reference to these jurisdictions is not made when Islamic law is addressed.

38 Coulson 1964, p. 75; Hasan (*Studies in Islamic Law, Religion and Society*) 1989, p. 49; Bannerman 1988, p. 31.
39 Dien 2004, pp. 35-36; Doi 1984, p. 2.
40 Fyzee 1974, pp. 14-17.

2.1.1 Sources of Islamic Law

There are two primary sources of Islamic law: the Qur'an and *sunnah*. In addition, there are three secondary sources of Islamic law: *ijma', qiyas* and *ijtihad*.

2.1.1.1 Qur'an

The first source of Islamic law is the holy book of the religion, the Qur'an. The Qur'an is divided into 114 chapters and each chapter consists of several verses, with a total of 6,666 verses.[41] Of all these verses, only 500 verses have a legal connotation.[42] All the other verses contain moral recommendations from which broad principles have been deduced.[43] The Qur'an is the revealed word of God presenting the Islamic beliefs in general form, suitable to changing circumstances in all times and places.[44] It could be regarded as a source of inspiration for legislation.[45] The primary purpose of the Qur'an is to lay down a way of life, which regulates the relationship between humans and humans (*mu'amalat*) and between humans and God (*'ibadat*).[46]

2.1.1.2 Sunnah

The second source of Islamic law is *sunnah*. *Sunnah* refers to the practices of the Prophet Muhammad, being representative for normative behaviour.[47] Since the principles of Islam as written in the Qur'an were revealed in general form, it was the role of the Prophet Muhammad to carry the message and elaborate on it.[48] The concrete details of *sunnah* are described in specific *hadith*. *Hadith* is the narrative of a particular occurrence, while *sunnah* is the rule deduced from the practice of the Prophet.[49]

2.1.1.3 Ijma'

When the Qur'an and *sunnah* do not provide an answer to a question, the consensus of the majority of the *Shari'ah* scholars is accepted as a source of Islamic law. The consensus of the majority of Islamic scholars is called *ijma'*. Although preferably *ijma'* refers to the consensus of the entire community (consensus of the *umma*), practicality and pragmatism lead to the acceptance

41 Doi 1984, pp. 21-22; Juynboll 1930, pp. 7-8.
42 Doi 1984, p. 36; Bannerman 1988, p. 34; Fyzee 1974, pp. 19-20.
43 Bannerman 1988, p. 34.
44 *Ibid*.; Hasan (*Studies in Islamic Law, Religion and Society*) 1989, p. 59.
45 *Cf.* Hasan (*Studies in Islamic Law, Religion and Society*) 1989, p. 58.
46 Burton 1990, pp. 9-10; Hasan (*Studies in Islamic Law, Religion and Society*) 1989, pp. 57-58.
47 Hallaq 2009a, pp. 16-19; Dien 2004, p. 38; Fyzee 1974, p. 20; Hasan (*Studies in Islamic Law, Religion and Society*) 1989, pp. 61-62; Pearl 1979, p. 4.
48 Dien 2004, p. 38; Hallaq 2009a, pp. 16-19; Bannerman 1988, p. 34.
49 Fyzee 1974, p. 20.

of *ijma'* as the consensus of the learned in the Islamic community (consensus of the *ulema*).[50]

There are two forms of *ijma'*: historical *ijma'* and contemporary *ijma'*.[51] Historical *ijma'* has been documented in the *fiqh* books throughout ages.[52] To reach contemporary *ijma'* on newly arising issues in society, discussions should commence, for example, through conferences where all *Shari'ah* scholars are invited in order to contribute to the process of *ijma'*.[53] The existence of an official authority is essential to reach full contemporary *ijma'*.[54] Within Islamic finance law, the AAOIFI is an authority that aims to reach contemporary *ijma'*. In the next chapter, the contributions of the AAOIFI to the development of Islamic finance law will be discussed.[55]

2.1.1.4 Qiyas

In cases where no consensus can be reached, the reasoning of a single *Shari'ah* scholar based on analogy may be accepted as a source of law. *Qiyas* refers to legal analogy, whereby the solution of one case is assimilated and applied to a similar case that has no solution.[56] The legal reasoning by analogy must, however, be based on the Qur'an, *sunnah* or *ijma'*.[57] *Qiyas* is regarded to consist of four elements: (i) a new case that requires a solution; (ii) an original case for which there is a solution in the revealed texts (the Qur'an or *sunnah*) or by consensus (*ijma'*); (iii) the attribute common to both cases (also referred to as the *ratio legis*, *i.e.* the true spirit of the law); and (iv) the solution for the original case that should be transposed to the new case.[58]

2.1.1.5 Ijtihad

Several *Shari'ah* scholars also acknowledge *ijtihad* as a secondary source of Islamic law, after *ijma'* and *qiyas*. *Ijtihad* means 'an effort' and refers to the effort of an individual to arrive at an individual judgement.[59] *Ijtihad* is the use of one's logical reasoning and common sense to deduce the true meaning of a legal rule in Islamic law.[60] In the tenth century, several Islamic scholars

50 Bannerman 1988, p. 37; Juynboll 1930, p. 38; Hasan (*Studies in Islamic Law, Religion and Society*) 1989, p. 67; Fyzee 1974, p. 20.
51 Dien 2004, pp. 46-48; Bannerman 1988, pp. 37; Juynboll 1930, p. 38.
52 Dien 2004, pp. 46-48.
53 Bannerman 1988, p. 37; Juynboll 1930, p. 38; Dien 2004, pp. 46-48; Hallaq 1997, pp. 75-81; Abdal-Haqq (*Understanding Islamic Law: From classical to contemporary*) 2006, pp. 17-18.
54 Dien 2004, pp. 46-48; Hallaq 1997, pp. 75-81.
55 *See* Chapter 3.
56 Dien 2004, pp. 51-53; Doi 1984, p. 70; Bannerman 1988, p. 38; Hallaq 1997, p. 83.
57 Doi 1984, p. 70.
58 Hallaq 2009a, pp. 22-23; Hallaq 1997, p. 83; Aghnides 1916, pp. 67-88.
59 Pearl 1979, p. 14; Doi 1984, p. 78; Dien 2004, pp. 51-53; Weiss 1978, pp. 199-200.
60 Doi 1984, p. 78; Bannerman 1988, p. 38; Pearl 1979, p. 14.

reached the conclusion that the exercise of *ijtihad* had exhausted itself and that from then on the doors of independent reasoning were closed.[61] No one would have the necessary qualifications for independent reasoning on Islamic law anymore.[62] However, recent studies have shown that the doors of *ijtihad* were never closed, that is, that the exercise of *ijtihad* continued.[63]

> Through a study of the efforts of the different schools of law over centuries, it becomes clear that after the times indicated as the closing of *ijtihad*, the *Shari'ah* scholars continued to perform *ijtihad*. The use of *ijtihad* was tacitly approved during these centuries. This provides a solid argument for the continuity of the practice of *ijtihad*.[64]

The Islamic scholar who practises *ijtihad* is called *mujtahid*: the interpreter who discovers the law, since he does not invent new rules but formulates rules that are already present in the revealed texts.[65] Every *mujtahid* can exercise *ijtihad* and no one knows which *mujtahid* is correct. This is expressed in the Islamic maxim 'every *mujtahid* is correct'.[66] As a result, religious texts are interpreted differently by *Shari'ah* scholars. This has led to inconsistencies within Islamic law. At the same time, it has led to development of Islamic law and Islamic jurisprudence, since there was room for different interpretations.

2.1.2 Islamic Jurisprudence

Islamic jurisprudence is referred to as *fiqh*. The purpose of the science of *fiqh* is to discover the true meaning of the objects of Islamic law, the *maqasad al-Shari'ah*. The most prominent goals of Islamic law are the protection of life, mind, offspring, private property and religion.[67] Within commercial transactions, the protection of private property should be held in high regard.

Fiqh can be divided into *usul al-fiqh* and *furu al-fiqh*. *Usul al-fiqh* is procedural Islamic law. It refers to the 'roots of Islamic jurisprudence', that is, the main sources of Islamic law.[68] *Shari'ah* scholars study the sources of Islamic

61 Weiss 1978, pp. 199-200; Pearl 1979, pp. 14-15.
62 The position which is taken from then on is that of *taqlid* (imitation) practised by the *muqallid* (the imitator). *Taqlid* refers to the acceptance of an Islamic rule, not on the basis of evidence drawn directly from the sources, but on the authority of other *Shari'ah* scholars. *See* Weiss 1978, pp. 199-200; Pearl 1979, pp. 14-15.
63 Hallaq 1984, pp. 3-41, with further references to other sources.
64 *See* Hallaq 1984, pp. 3-41.
65 Weiss 1978, pp. 199-200.
66 Hallaq 2009a, p. 27.
67 Hallaq 2009a, pp. 24-25; Hallaq 1997, p. 89.
68 Juynboll 1930, pp. 32-44; Masud (*Studies in Islamic Law, Religion and Society*) 1989, pp. 32-33; Coulson 1964, pp. 75-76; Hallaq 1997, pp. 30-35; Burton 1990, pp. 15-17.

law and contribute to Islamic jurisprudence as discussed in the previous subsection.[69] *Furu al-fiqh* is substantive Islamic law.[70] Since Islamic law is not codified, these legal rules are discussed and developed in *fiqh* books, that is, doctrine.[71] The Islamic finance principles and the rules of Islamic private law, as discussed in Sections 2.2 and 2.3 of this chapter, are substantive rules of Islamic law.

The contributions of the *Shari'ah* scholars throughout the ages have resulted in the establishment of different *fiqh* schools of Islamic law: the *madhahib*.[72] There is no hierarchy between the different schools of Islamic law. As the maxim 'every *mujtahid* is correct' illustrates, each school of law may be correct and there is not one single correct interpretation of Islam.[73] Therefore, there has been much divergence in the interpretation of Islamic law. For example, with regard to Islamic finance law, the practice of Islamic finance in Malaysia differs from the practice of Islamic finance in Middle Eastern countries due to different interpretations of Islamic finance law by different *madhahib*.

Due to the hardship to study all *fiqh* books in order to answer a specific question, Islamic law provides the possibility to acquire a legal advice from a *Shari'ah* scholar.[74] Such advice is called a *fatwa*: a legal opinion issued by a *Shari'ah* scholar in response to a question posed by an individual.[75] Contrary to a binding judgment of a judge (*qadi*), a *fatwa* issued by a *Shari'ah* scholar is a non-binding legal opinion.[76] Within Islamic finance transactions, *Shari'ah* scholars are consulted for a *fatwa* on the *Shari'ah* compliance of a transaction. A *fatwa* is issued by a board of *Shari'ah* scholars. Such board of (often three) *Shari'ah* scholars is referred to as the *Shari'ah* supervisory board. Once the *Shari'ah* supervisory board has accepted a transaction as *Shari'ah*-compliant in its *fatwa*, the product can be offered as an Islamic finance product. *Shari'ah* supervisory boards may have different interpretations of Islamic finance law, depending on the *madhahib* they adhere to, resulting in divergence within the practice of Islamic finance.

69 *See* Section 2.1.1 of this chapter.
70 Hallaq 1997, pp. 153-161; Fyzee 1974, p. 23; Masud, Messick & Powers (*Islamic Legal Interpretation: Muftis and Their Fatwas*) 1996, p. 4.
71 Juynboll 1930, pp. 26-29.
72 *Ibid.*, p. 18. There are two main divisions in Islam: *Sunni* and *Shi'a*. Four *Sunni* schools of Islamic law are: *Hanafi*', *Maliki*, *Shafi'i* and *Hanbali*. Three *Shi'a* schools of Islamic law are: *Ithna 'Ashari*, *Isma'ili* and *Zaydi*.
73 *See* Section 2.1.1.5 of this chapter.
74 Juynboll 1930, pp. 29-32.
75 Masud, Messick & Powers (*Islamic Legal Interpretation: Muftis and their Fatwas*) 1996, p. 4; Juynboll 1930, pp. 29-32.
76 Masud, Messick & Powers (*Islamic Legal Interpretation: Muftis and their Fatwas*) 1996, p. 3.

2.2 Islamic Finance Principles

Through a study of the sources of Islamic law, *Shari'ah* scholars formulate Islamic principles. According to a general principle of Islamic law, all activities are permissible unless there is an explicit prohibition in the religious texts. Within Islamic law, there is a general and explicit prohibition of engagement in *haram* activities. *Haram* means illegal under Islamic law and refers to immoral activities. It is the opposite of *halal*, which means legal under Islamic law. With regard to Islamic finance, *haram* activities are investments in immoral industries such as the arms, drugs, alcohol, gambling, prostitution and pornography industry. As a prerequisite to all transactions, investments in and activities relating to industries that are considered *haram* are forbidden. Furthermore, there are two Islamic principles that specifically relate to Islamic finance: (i) the prohibition of *riba*; and (ii) the avoidance of *gharar*. In what follows, these two principles will be discussed in more detail.

2.2.1 *Riba*

Riba is often divided into three different forms: the *riba al-jahiliyya*, the *riba al-fadl* and the *riba al-nasi'a*.[77] In *fiqh* literature there has been much debate on the interpretation of *riba*. The predominant view within *fiqh* is that any increase charged over the principal in a loan transaction is *riba*. According to a dissenting view, the prohibition of *riba* relates to the exploitation of the economically disadvantaged in society, whether the exploitation is in the form of interest or any other form of profit made in a transaction.[78] The contemporary Islamic finance industry is built upon the majority view of the *Shari'ah* scholars that all forms of interest are prohibited by the prohibition of *riba*. Without engaging in the religious discussions, I will take this view as my starting point while discussing the legal aspects of Islamic finance in the following chapters. Before doing so, this view needs to be elaborated further.

One of the most discussed verses of the Qur'an with regard to *riba* is verse 2:275, according to which God has permitted trade, but prohibited *riba*:

77 *Riba al-jahiliyya* refers to *riba* that was charged during the pre-Islamic period in Arabia. When a creditor could not repay his debts at maturity, the debt was doubled and redoubled. This resulted in inhuman practices. *See* Ibn Rushd (Nyazee) 1996, p. 158; Saleh 1986, pp. 13-14; El-Gamal 2006, pp. 49-50. *Riba al-fadl* refers to an excess of one of the counter values in an on-the-spot transaction. This form of *riba* is also referred to as *riba* by way of excess. *Riba al-nasi'a*, also known as *riba* by way of deferment, refers to *riba* charged when delivery of one of the counter values is delayed in a transaction. This form of *riba* is often compared with conventional interest. For more on the different forms of *riba*, *see* Saeed 1996, pp. 17-40.

78 For a discussion of both views and further references to (*fiqh*) literature, *see* Saeed 1996, pp. 17-40.

> *Those who devour [riba] will not stand except as stand one whom the Evil one by his touch [h]ath driven to madness. That is because they say: 'Trade is like [riba]', but Allah hath permitted trade and forbidden [riba]. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat ([the] offence) are companions of the Fire: They will abide therein (for ever).*[79]

The *Shari'ah* scholars who support the view that all forms of interest are prohibited by the prohibition of *riba* argue that *riba* is contrasted in this verse with profit resulting from a sale transaction. Therefore, they say, all forms of interest are prohibited, while profit made through sale transactions is permissible. Under the rules of *Shari'ah*, granting a loan is considered an act of charity.[80] It is improper to make profit on a loan by charging interest to the borrower. This does not mean that making profit itself is forbidden within Islam. Quite the contrary: Islamic law encourages circulation of wealth, investment and profit.[81] Profit must, however, be made through trade and other similar activities. A return on investment is only justified when the investor takes a commercial risk. Lending money does not qualify as a commercial risk because the risk of non-repayment (poor debtor creditworthiness, for example) is deemed insufficient to warrant charging interest.[82] Profitability requires taking a real commercial risk. As a result, the concept of profit-and-loss-sharing is extremely important in Islamic finance. Financiers generally do not receive interest on the funds they provide, but instead participate in the project to the extent that they share in any profits or losses made. The profit-and-loss-sharing element of Islamic finance is particularly noticeable in Islamic finance contracts such as *musharaka* and *mudarabah*. Both Islamic finance contracts will be discussed in the next chapter.[83]

The prohibition of *riba* reaches even further. *Shari'ah*-compliant transactions preclude making money with money. Money itself may not be a source of profit, because money has no intrinsic value within Islam.[84] The ultimate purpose of money is to help fulfil basic needs, such as food, clothes and shelter. In this approach money must be seen (and used) only as a means of exchange, not as a basic need in itself.[85] This position is at the heart of the *bay' al-dayn*

79 Qur'an 2:275 , translation of the Qur'an by Yusuf Ali.
80 Moghul & Ahmed 2003, p. 168.
81 Qur'an 4:29; 2:275.
82 *Cf.* Hanif 2008, p. 10.
83 *See* Section 3.1 of Chapter 3.
84 Islamic law does not reject the time value of money. For more on the time value of money within Islamic finance, *see* El-Gamal 2000a, pp. 4-5 & 34-36.
85 There are several *hadith* on the use of money. For a discussion of these *hadith*, *see* El-Gamal 2000a, pp. 2-4; Jabbar 2009a, pp. 23-32.

doctrine, that is, the trade in claims.[86] Most *Shari'ah* scholars agree that the prohibition of *riba* extends to a prohibition of the trade in claims because trading in claims is similar to the forbidden use of money as a source of profit.[87] This does not mean that claims cannot be transferred at all. Claims can be transferred, but only at face value, since any increase or decrease would resemble the forbidden *riba*.

Concluding, it is permissible to make profit, but the realised profit cannot be interest. The decisive feature for this distinction is the asset that is the subject matter of the transaction: profit is made through trade in tangible property, while interest is a form of profit generated through trade in money (intangible property). Furthermore, profitability requires taking a real commercial risk from an Islamic perspective and, consequently, there is an emphasis on the concept of profit-and-loss-sharing within Islamic finance.

2.2.2 *Gharar*

The second Islamic finance principle is that *gharar* should be avoided as much as possible within Islamic finance transactions. *Gharar* is literally translated as 'uncertainty' or 'risk'.[88] It refers to contractual uncertainty within Islamic finance transactions.

The concept of *gharar* originates from the Qur'anic verse 2:219, which prohibits gambling:

> *They ask thee concerning wine and gambling. Say: 'In them is great sin, and some profit, for men; but the sin is greater than the profit'. They ask thee how much they are to spend; [say]: 'What is beyond your needs'. Thus doth Allah [make] clear to you His [signs]: In order that ye may consider.*[89]

The concept of *gharar* is further explained in several *hadith*, giving more substance to the aim to avoid *gharar*. Based upon those *hadith*, specific rules for Islamic contract law have been formulated.[90] An example of a *hadith* dealing with uncertainty is the following:

86 Usmani 2002, pp. 100-101.
87 The *Shari'ah* scholars in Malaysia, on the contrary, do not agree with the view that the *riba* prohibition extends to the trade in claims. They allow claims to be traded (*bay' al-dayn*), *see* Securities Commission Shariah Advisory Council 2006, p. 19.
88 Saleh 1986, p. 3; Vogel & Hayes 1998, pp. 87-88; El-Gamal 2000a, pp. 6-8; El-Gamal 2000b, pp. 4-6; El-Gamal 2006, pp. 59-60; Ayub 2007, pp. 57-61; Hamoudi 2008, pp. 441-442.
89 Qur'an 2:219, translation of the Qur'an by Yusuf Ali.
90 *See* Section 2.3 of this chapter.

Narrated Ibn Umar:

The Prophet said, '[h]e who buys foodstuff should not sell it till he has received it'". [91]

On the basis of this *hadith*, for example, *Shari'ah* scholars have argued that due to the presence of *gharar*, one cannot sell property before he has received it. This is elaborated further within Islamic private law.[92] Before discussing the rules of Islamic private law, I will discuss the essence of *gharar* and its impact on Islamic finance contracts.

According to the principle of *gharar*, excessive uncertainty in contracts must be avoided as much as possible.[93] Islamic law recognises that it is unrealistic to completely rule out uncertainty in transactions. In other words, not all uncertainty leads to an invalid contract. A contract is invalidated under Islamic law due to *gharar* if the essentials of a contract remain unspecified. The *gharar* doctrine aims to avoid information asymmetry on the essential elements of a contract between contracting parties, which could otherwise arise if the essential elements of the transaction are not stipulated in the contract. A contract is invalid on the grounds of *gharar*, if:[94]

1. the contract is reciprocal, that is, it creates obligations for all contracting parties;
2. the *gharar* relates to the essential elements of the contract, such as the price, the delivery, the quality and the quantity of the subject matter of the contract;
3. the *gharar* with regard to the essential elements of the contract is major and excessive; and
4. there is no need in society that cannot be met otherwise than through the use of major *gharar* with regard to the essential elements of the contract.

As a result of the *gharar* doctrine, *qimar* (gambling) and *mayseer* (speculation) are also discouraged within Islamic law.[95] Both words are used identically in the Arabic language.[96] *Qimar* and *mayseer* pertain to yields that depend solely on luck or chance, such as gambling. Excessive speculation and gambling are prohibited in transactions because profits achieved through them cannot be

91 Sahih Bukhari, Volume 3, Book 34 on Sales and Trade, Number 343, translated by M.M. Khan.
92 *See* Section 2.3 of this chapter.
93 Qur'an 2:90; 2:91.
94 Ibn Rushd (Nyazee) 1996, pp. 179-187; Saleh 1986, pp. 52-55; El-Gamal 2006, pp. 58-59; Ayub 2007, pp. 57-61; Hamoudi 2008, pp. 441-442; Fadeel (*Islamic Finance: Innovation and Growth*) 2002, p. 91.
95 Gambling is directly prohibited in the Qur'an. *See* Qur'an 2:219; 5:90; 5:91.
96 Ayub 2007, p. 61.

justified. Yet ordinary entrepreneurial risks are not included in this ban. In this context, conventional derivative contracts are considered to contain elements that are akin to speculation and could be prohibited on grounds of *qimar* and *mayseer*.[97]

2.2.3 *Riba* and *Gharar* in the Light of the Special Contracts of the Dutch Civil Code

The prohibition of *riba* and the avoidance of *gharar* are less peculiar to Dutch law than one might think at first glance. The Netherlands has not been unfamiliar with the prohibition of charging interest. As a matter of fact, in order to avoid charging interest, a special contract was codified in the former DCC: the contract of perpetual interest (*overeenkomst van gevestigde of altijddurende rente*). The former DCC also had a special contract of gaming and betting (*overeenkomst van spel en weddenschap*), dealing with uncertainty in contracts. In the light of the principles of *riba* and *gharar*, both contracts, which have been transferred to the current book 7A DCC, will be discussed in this subsection.

The contract of perpetual interest is a contract whereby a party lends a principal which will not be recovered against payment of interest.[98] The contract dates back from a time when the Catholic Church had a powerful position in Dutch society and did not allow the creation of wealth without productive effort.[99] Therefore, charging interest on a loan was forbidden and considered to be a sin. As a result, the contract of perpetual interest was introduced in practice. The reasoning was such that money was transferred to the 'borrower', who from then on 'owned' the money. In consideration for the 'transfer', the 'borrower' would pay perpetual interest to the 'lender'. However, since there was no loan (over which interest had to be paid), this contract was apparently permissible. This does not mean that the principal was not paid back and interest was paid until the end of days: the 'borrower' was allowed to pay back the principal, after which the contract would come to an end.[100]

Can the contract of perpetual interest be used to structure Islamic finance transactions under Dutch law? The roots of the contract of perpetual interest relate to a religious prohibition of interest. The contract has this in common with Islamic finance transactions, where interest is not permitted either due to the prohibition of *riba*. The rationale for the prohibition of interest in the Netherlands is also comparable to the rationale for the prohibition of *riba* in Islamic finance: in both cases, making money without any productive effort

97 Hanif 2008, p. 10.
98 *See* Art. 7A:1807 DCC.
99 *See* Asser/Van Schaick 2012 (7-VIII*), no. 262.
100 *See* Art. 7A:1808 (1) DCC. *See also* Asser/Van Schaick 2012 (7-VIII*), no. 264.

is discouraged. Nonetheless, the contract of perpetual interest is in conflict with the prohibition of *riba*. The payment of money for the use of money is impermissible as such due to the prohibition of *riba*. Therefore, the contract of perpetual interest cannot be used to structure Islamic finance transactions.

Another special contract that deserves closer consideration is the contract of gaming and betting in book 7A DCC. The contract of gaming and betting falls under the aleatory contracts (*kansovereenkomsten*) under Dutch law. There is no definition of the contract of gaming and betting in book 7A DCC. In literature the contract has been defined as an aleatory contract that makes the chances of parties to profit and loss dependent on an uncertain event, to which the parties have no or only different interests before the conclusion of the contract.[101] No material distinction is made between gaming and betting.[102] According to Articles 7A:1825 and 7A:1828 DCC, the obligations arising from such contract are not enforceable. The parties to the contract cannot contractually agree otherwise because the provisions applicable to the contract of gaming and betting are mandatory law.[103] The prevailing view is that the obligations are natural obligations (*natuurlijke verbintenissen*) within the meaning of Article 6:3 DCC, that is, obligations that cannot be enforced by law.[104] The obligations of the contract of gaming and betting are not enforceable because the contract is regarded as being contrary to good morals, having addictive features and having no contribution to society.[105] Other contracts with an excessive speculative character may also fall within the scope of the rules applicable to the contract of gaming and betting.[106]

The contract of gaming and betting and its legal regime under Dutch law show similarities to the principle of *gharar* under Islamic law. The principle of *gharar*, however, reaches further than a sole prescript on the avoidance of uncertainty or the invalidation of contracts with excessive speculative characteristics. The principle of *gharar* has determined the substance of Islamic contract law. Based on the principle of *gharar*, concrete rules of Islamic private law have been formulated. In the next section, these rules will be discussed.

101 *See* Asser/Van Schaick 2012 (7-VIII*), no. 280.
102 *See* Dutch Supreme Court 9 June 1899, *W* 7296.
103 Art. 7A:1827 DCC.
104 *See* Asser/Van Schaick 2012 (7-VIII*), no. 289. *See* Wessels 1988.
105 *See* Asser/Van Schaick 2012 (7-VIII*), no. 288.
106 *See* Asser/Van Schaick 2012 (7-VIII*), no. 283, with further references to other sources.

2.3 Islamic Private Law

Shari'ah scholars have formulated specific rules of Islamic private law based on the principles of *riba* and *gharar*. Ibn Rushd[107] clarified the importance of *riba* and *gharar* for Islamic private law by saying that the invalidity of contracts can have four legal causes:

1. the prohibition of the property itself under Islamic law;
2. *riba*;
3. *gharar;* or
4. conditions that lead to one of 2 or 3 or both of them.[108]

The first legal cause refers to property that is *haram*. For example, a sale contract pursuant to which alcohol is sold is invalid under Islamic law. The following three legal causes that invalidate a contract under Islamic law relate to *riba* and *gharar*. As appears from the enumeration of Ibn Rushd, the legal validity of a contract is mainly determined by *riba* and *gharar* under Islamic private law.

As with most areas of Islamic law, Islamic private law is documented in *fiqh* books, since there has not been a complete codification of Islamic law. The rules of Islamic private law can be divided into rules of Islamic property law and rules of Islamic contract law. Islamic property law and Islamic contract law form the foundation of Islamic finance law and, therefore, determine the contents of Islamic finance contracts.

> The *Mecelle* was one of the first attempts to codify parts of Islamic private law. It was the civil code of the Ottoman Empire during the 19th and the beginning of the 20th century. The *Mecelle* is, however, not in force anymore and is not consulted for Islamic finance transactions.

2.3.1 Islamic Property Law

Under Islamic property law, property is called *mal*. It is defined as a corporeal object, the *ayn*.[109] *Ayn* refers to an existing thing that can be subject to human control and that can be determined.[110] Everything that is not *ayn* is referred to

107 Ibn Rushd (1126-1198), also known as Averroes, was a well-known judge, philosopher and physician. *See* Chapter 1.
108 Ibn Rushd (Nyazee) 1996, p. 155.
109 *Ibid*., pp. 154-155; Schacht 1964, p. 134; Vogel & Hayes 1998, pp. 94-95. *Cf.* El-Gamal 2006, p. 36; Doi 1984, p. 356; Juynboll 1930, pp. 269-271; Ibrahim 2008, p. 689.
110 Ibn Rushd (Nyazee) 1996, pp. 154-155; Juynboll 1930, p. 268; Vogel & Hayes 1998, pp. 94-95.

as *dayn*.[111] *Dayn* literally means 'debt' and it can refer to an obligation (either to perform an act or to pay money).[112] The restriction of property to corporeal objects under Islamic property law can be explained through a study of the prohibition of *riba*.[113] The trade in claims (*bay' al-dayn*) is subject to specific rules because it resembles the forbidden *riba*: in monetary terms, a claim is comparable to money. As a result of the prohibition of *riba*, the trade of *dayn* for *dayn* (*e.g.* payment of cash for a claim) should always occur at face value.[114] The general rules of Islamic property law do not apply. The scope of Islamic property law is, thus, limited only to corporeal objects (*ayn*).

The most important right on property is the right of ownership. The right of ownership is called *milk*. It refers to the complete and exclusive right to dispose of property with the exclusion of other parties.[115] The owner of property is called *malik*.[116] Under Islamic property law, an agreement suffices for the transfer of the right of ownership of property.[117] The legal consequence of a validly concluded contract that intends to transfer the right of ownership of property to the transferee is the immediate transfer of the right of ownership from the transferor to the transferee.[118] Hence, Islamic law has a consensual system whereby the transfer of the right of ownership occurs by virtue of the contract itself, as opposed to legal systems where the transfer of the right of ownership requires delivery of the property, as is the case under Dutch law.[119]

2.3.2 Islamic Contract Law

A contract is called *aqd* under Islamic law. Islamic contract law requires mutual consent to conclude a contract. The contracting parties must intend to enter into the contract.[120] The parties show their intention through declarations: offer (*idjab*) and acceptance (*qaboel*).[121] The Qur'an explicitly encourages

111 Vogel & Hayes 1998, pp. 94-95 & 114-115; Ibn Rushd (Nyazee) 1996, pp. 154-155; Schacht 1964, p. 134; Juynboll 1930, p. 268.
112 Ibn Rushd (Nyazee) 1996, pp. 154-155; Vogel & Hayes 1998, pp. 94-95 & 114-115.
113 *See* Section 2.2.1 of this chapter.
114 For more on this, *see* Ibn Rushd (Nyazee) 1996, pp. 154-155; Vogel & Hayes 1998, pp. 114-124.
115 Schacht 1964, pp. 134-136; Vogel & Hayes 1998, pp. 94-95; Juynboll 1930, p. 266; Doi 1984, p. 356; Hallaq 2009b, pp. 296-297.
116 Schacht 1964, pp. 134-136; Vogel & Hayes 1998, pp. 94-95; Juynboll 1930, p. 266.
117 Juynboll 1930, p. 268; Van Bakelen (*Recht van de Islam 3: Teksten van het op 21 juni 1985 te Leiden gehouden 3e symposium*) 1985, p. 49. Also *cf.* Schacht 1964, pp. 140-142.
118 Coulson 1984, pp. 19-20; Hassan 2002, pp. 285-287; Vogel & Hayes 1998, pp. 94-95; Juynboll 1930, p. 268; Van Bakelen (*Recht van de Islam 3: Teksten van het op 21 juni 1985 te Leiden gehouden 3e symposium*) 1985, p. 49. Also *cf.* Schacht 1964, pp. 140-142; Doi 1984, p. 358.
119 Art. 3:84 (1) DCC.
120 Vogel & Hayes 1998, pp. 59-61; El-Gamal 2006, pp. 42-44; Usmani 2002, p. 38; Moghul & Ahmed 2003, pp. 165-168; Baillie 1850, pp. 1-2.
121 Ibn Rushd (Nyazee) 1996, pp. 204-206; Schacht 1964, p. 145; Juynboll 1930, pp. 267-269; Van Bakelen (*Recht van de Islam 3: Teksten van het op 21 juni 1985 te Leiden gehouden 3e symposium*)

parties to write down their obligations.[122] Contracts can also be concluded orally under Islamic contract law, since there is no strict requirement to write down the parties' respective obligations.[123]

Islamic law does not have a general theory of contracts. It contains specific rules for various nominate contracts.[124] A study of the nominate contracts illustrates that the rules for the contract of sale (*bay'*) are the closest one could get to a general theory of contract law. The contract of sale is used by Islamic scholars as the prototype contract on the analogy (*qiyas*) of which all other contracts are drawn.[125] I will next discuss the Islamic rules for the contract of sale.

On the basis of an analysis of the requirements for a valid contract of sale in Islamic jurisprudence, I have formulated nine rules that should be respected in order to conclude a valid contract of sale.[126] These rules are formulated by *Shari'ah* scholars through a study of the general prohibition on engaging in *haram* activities and the two principles of *riba* and *gharar*. I divide the nine rules for a valid contract of sale into three categories: (i) there are four rules that relate to the subject matter of the sale; (ii) there are two rules that relate to the legal position of the seller; and (iii) there are three rules that relate to the terms and conditions of the contract of sale.

The four rules that relate to the subject matter of the sale are:

I. the subject matter of the sale cannot be a *haram* property;
II. the subject matter of the sale must be a property of value;
III. the subject matter of the sale must be specifically stipulated in the contract of sale; and
IV. the subject matter of the sale must exist at the time of the sale.

These rules are mainly formulated to respect the principle of *gharar,* except the first rule that aims to avoid the trade in *haram* property. The property sold should be a property of value and it should be specifically identified, that is, its quality, quantity and its characteristic features should be stipulated in the contract in order to avoid *gharar*. Under Islamic contract law it is, furthermore,

1985, pp. 49-50; Doi 1984, pp. 356-358; Moghul & Ahmed 2003, pp. 165-168; Hassan 2002, pp. 257-262; Thomas (*Structuring Islamic Finance Transactions*) 2005, p. 24; Baillie 1850, pp. 1-2.

122 Qur'an 2:282.

123 Juynboll 1930, pp. 269-270; Van Bakelen (*Recht van de Islam 3: Teksten van het op 21 juni 1985 te Leiden gehouden 3e symposium*) 1985, p. 50; Moghul & Ahmed 2003, pp. 165-168; Thomas 2005, p. 24.

124 Vogel & Hayes 1998, pp. 97-98; Hassan 2002, pp. 282-285; Buang 2004, pp. 171-174.

125 Vogel & Hayes 1998, pp. 97-98; Schacht 1964, pp. 151-152.

126 *See* Ibn Rushd (Nyazee) 1996, pp. 179-192; Usmani 2002, pp. 38-40; El-Gamal 2006, pp. 42-43; Moghul & Ahmed 2003, pp. 165-168; Ibrahim 2008, pp. 690-691; Vogel & Hayes 1998, pp. 101-105; Thomas (*Structuring Islamic Finance Transactions*) 2005, pp. 25-27; Visser 2009, pp. 75-79; Obaidullah 2005, pp. 29-30; Baillie 1850, pp. 4 & 29-30; Coulson 1984, pp. 19-21; Kamali 2000, pp. 99-103; Schacht 1964, p. 138; Ayub 2007, pp. 57-61; Zahraa & Mahmor 2002, pp. 379-397.

not permitted to sell property that has not come into existence yet due to the uncertainty regarding its existence.

The two rules that relate to the legal position of the seller are:

V. the seller must have the right of ownership of the property at the time of entering into the contract of sale; and
VI. the property must be in the possession of the seller at the time of entering into the contract of sale.

These two rules are also formulated on the basis of *gharar*. In Subsection 2.2.2 of this chapter, reference was made to a *hadith*, according to which the Prophet Muhammad said that a person cannot sell foodstuff until he has received it. On the basis of such *hadith*, *Shari'ah* scholars formulated the rules that a seller should have the right of ownership of a property and that that property must be in his possession at the time of entering into the contract of sale.

Finally, there are three rules that relate to the conditions in the contract of sale:

VII. the delivery of the property must be certain between the contracting parties (the delivery should not be made dependent upon a(n) (future) event) and stipulated in the contract of sale;
VIII. the sale price must be stipulated in the contract of sale; and
IX. the contract of sale must not be made contingent upon another transaction unless it has a direct link with the contract of sale according to the usage of trade.

These three rules are, once again, formulated on the basis of *gharar*. A valid contract of sale is concluded under Islamic contract law after all the above formulated nine rules are met: the nine rules are cumulative requirements for a valid contract of sale.

The legal consequence of a valid contract of sale is the immediate transfer of the right of ownership of property from the seller to the buyer. Therefore, it is not possible to conclude a contract of sale where the parties intend to transfer the right of ownership of property at a future date, *i.e.* a future sale contract.[127] Alternatively, a *wa'd* is used in Islamic finance transactions. A *wa'd* is a binding promise.[128] Binding promises fulfil an important role, next to contracts, under Islamic contract law. A promisor can promise to sell property at a future date to his counterparty. At the future date, the parties have to enter into a new contract of sale to effect the sale. From an Islamic law perspective,

127 The contracts of *salam* and *istisna'* both form an exception to the impermissibility of future sale contracts. Both contracts are discussed in the next chapter. *See* Section 3.2 of Chapter 3.
128 Usmani 2002, pp. 49-52; Vogel & Hayes 1998, pp. 125-128; Visser 2009, pp. 75-79.

the promise of *wa'd* is binding on the promisor and it is legally enforceable in court.[129] It has the same legal effect as a contract with the unilateral obligation to transfer a property at a future date in many jurisdictions.

2.3.3 Comparison between Islamic Private Law and Dutch Private Law

There are three similarities when Islamic private law and Dutch private law are compared with each other. First, both legal systems require offer and acceptance for the conclusion of a contract.[130] Second, according to both legal systems, the contracting parties must reach agreement on the essentials of a contract. Islamic contract law provides an enumeration of those essentials.[131] Dutch law does not provide such strict enumeration. The required essential elements depend on the type of contract that is concluded under Dutch law. For example, an essential element of the contract of sale under Dutch law is agreement on the property that is the subject matter of the contract,[132] but the price does not have to be certain.[133] Third, both legal systems require that the stipulated obligations of the contracting parties are determinable.[134] In a contract of sale, for example, the subject matter of the sale should be sufficiently determinable under both Islamic and Dutch contract law.[135] Where Islamic contract law requires the subject matter to be specifically identified, Dutch contract law requires that it is sufficiently determinable. It seems that Islamic contract law requires for a more specific determinability of the subject matter of the contract of sale than Dutch contract law.

Comparing these two legal systems also brings two differences to the surface. The first difference relates to the definition of property. Property (*mal*) is restricted to corporeal objects under Islamic property law. This differs from Dutch property law, where property (*goederen*) is defined as all tangible properties (*zaken*) and all patrimonial rights (*vermogensrechten*).[136] The definition of *mal* under Islamic property law mainly resembles the definition of tangible

129 The International Islamic Fiqh Academy of the Organization of the Islamic Conference issued a *fatwa* in which it ruled that a promise is binding on the promisor and it should be legally enforceable in court in case of a *murabaha* contract, *see* OIC Islamic Fiqh Academy, Res. No. 40-41 (2/5 & 3/5) 1988. For discussions on the legal enforceability of the promise of *wa'd*, *see* Usmani 2002, pp. 49-52; Vogel & Hayes 1998, pp. 125-128; Visser 2009, pp. 75-79; Al-Masri 2002, pp. 29-32; Laldin 2009, pp. 1-2.

130 *See* Section 2.3.2 of this chapter; *see* Art. 6:217 DCC.

131 *See* Section 2.3.2 of this chapter, *see* Asser/Hartkamp & Sieburgh 2010 (6-III*), no. 96.

132 *See* Art. 7:1 DCC.

133 *See* Art. 7:4 DCC. Before the introduction of the DCC in 1992, the price had to be certain, see Arts. 1494 and 1501 former DCC.

134 *See* Art. 6:227 DCC.

135 *See* Rule III of Islamic contract law under Section 2.3.2 of this chapter; *see* Art. 7:1 DCC in conjunction with 6:227 DCC.

136 Art. 3:1 DCC.

property under Dutch property law, that is, corporeal objects susceptible of human control.[137] Patrimonial rights under Dutch property law mainly resemble *dayn* (claims) under Islamic property law.[138] Hence, from a Dutch law perspective, one should be aware that Islamic property law only deals with movable property (*roerende zaken*) and immovable property (*onroerende zaken*).

The second difference relates to the transfer of the right of ownership of property. Islamic property law does not require the delivery of property in order to transfer the right of ownership of property to the transferee. Only a contract suffices to transfer the right of ownership of property. Dutch property law, however, requires delivery of the property in order to transfer its right of ownership.[139] Otherwise, the transferee does not become the owner of the property.

However, the significance of the delivery of property for Islamic private law appears from the rules of Islamic contract law. The above formulated rule VII of Islamic contract law states that the delivery of property should be certain: the contracting parties should stipulate when and how the property is delivered. Furthermore, according to rule VI, property cannot be sold if the transferor does not have its possession. A transferee can acquire the right of ownership of property by virtue of contract without delivery of the property. He, however, cannot dispose of the property until he has acquired its possession. This stresses the importance of the delivery of property. The transferee can dispose of the property once the property has been delivered to him. Hence, his right of ownership becomes effective towards third parties after delivery of the property to him.

Furthermore, Rules IV and V of Islamic contract law deserve attention. According to these rules, it is not possible to sell non-existing or not-yet-owned property under Islamic private law. Not respecting these rules results in an invalid contract of sale and, consequently, the right of ownership of the property is not transferred. Although it is possible to sell non-existing or not-yet-owned property under Dutch law, it is not possible to transfer the right of ownership of such property.[140] In essence, both legal systems do not allow the transfer of the right of ownership of future property, that is, property not owned by the transferor at the moment of the transfer, even though both legal

137 *See* Art. 3:2 DCC.
138 *See* Art. 3:6 DCC.
139 Art. 3:84 (1) DCC.
140 Art. 3:97 (1) DCC allows the delivery in advance of future property. The right of ownership of future property is, however, not transferred to the transferee due to Art. 3:84 (1) DCC, until the transferor has acquired its right of ownership, more specifically its right to dispose of the property (*beschikkingsbevoegdheid*).

systems differ significantly with regard to the way in which this fact can be explained.

2.4 Concluding Remarks

In this chapter I discussed the development of Islamic law and Islamic jurisprudence. Throughout ages, *Shari'ah* scholars have studied the sources of Islamic law to formulate rules for new arising challenges in society. Even today, *Shari'ah* scholars are consulted for Islamic finance transactions to provide their approval for a structure. With regard to Islamic finance, two principles should be taken into account: the prohibition of *riba* and the avoidance of *gharar*. These two Islamic finance principles have also determined the specific rules of Islamic private law. For example, due to the prohibition of *riba*, the concept of property is restricted to tangible property under Islamic property law. The rules of Islamic private law, in turn, determine the contents of Islamic finance contracts. In the next chapter I will discuss these Islamic finance contracts.

3 Islamic Finance Contracts

Based on the Islamic finance principles and rules of Islamic private law that were discussed in the previous chapter, nominate contracts have been developed under Islamic law from the Middle Ages onwards. With the emergence of Islamic finance during the second half of the 20th century, Islamic scholars revisited the nominate contracts to use them as building blocks for Islamic finance transactions.[141] There was already much written on the nominate contracts, so the foundation of Islamic finance law already existed. However, the application of these contracts to new transactions required the creation of a new set of rules.

Initially, there was divergence in the formulation of the rules of Islamic finance law due to differences in interpretation of the religious texts. The Islamic finance industry was in need of harmonisation of the *Shari'ah* rules. A breakthrough in this process was the issuance of the *Shari'ah* Standards of the AAOIFI. The AAOIFI issues various international standards, such as Accounting Standards, Auditing Standards, Governance Standards, Ethics Standards and *Shari'ah* Standards, with the purpose of harmonising the Islamic finance industry. In this research, the AAOIFI *Shari'ah* Standards are used to determine the substance of Islamic finance law.

The AAOIFI *Shari'ah* Standards are the product of contemporary *ijma'*. *Shari'ah* scholars gathered to discuss these rules and the AAOIFI as an authoritative institution adopted the rules. The *Shari'ah* Standards were discussed and adopted in several meetings during the first decade of the 21st century. In 2007, the full text of the first set of *Shari'ah* Standards was compiled. *Ijma'* is a source of Islamic law and gives the AAOIFI *Shari'ah* Standards legitimacy from an Islamic law perspective. I will use the AAOIFI *Shari'ah* Standards in this study to discuss the rules of Islamic finance law.

> I do acknowledge that there is still no full *ijma'* on the AAOIFI *Shari'ah* Standards because some *Shari'ah* scholars do not agree with the interpretations of the religious texts by the AAOIFI *Shari'ah* Board. The *Shari'ah* Advisory Council of the Malaysian Securities Commission, for example, has a different interpretation of some of the religious texts. Nonetheless, I use the AAOIFI *Shari'ah* Standards

141 DeLorenzo & McMillen (*Islamic Finance: The Regulatory Challenge*) 2007, pp. 143-145; McMillen 2006, p. 147.

to determine Islamic finance law for two reasons. First, the AAOIFI *Shari'ah* Standards are one of the few compiled sets of rules on Islamic finance law. Other *Shari'ah* scholars have provided *fatwa* on an *ad hoc* basis, but they do not provide a complete systemised overview of the rules of Islamic finance law. The abovementioned *Shari'ah* Advisory Council of the Malaysian Securities Commission is one of the few examples of other institutions that also provided a complete systemised overview of the rules of Islamic finance law. However – and this bring me at my second reason to use the AAOIFI *Shari'ah* Standards in this research – the *Shari'ah* Board of the AAOIFI consists of more than 20 members, representing all four schools of Islamic law (*madhahib*), issuing standards for the international market, while the *Shari'ah* Advisory Council of the Malaysian Securities Commission consists of eight members, mainly using interpretations of the *Shafi'i* school of Islamic law, focusing on the Malaysian market.

Traditionally, Islamic finance was based on partnership contracts. These partnership contracts are regarded as the most *Shari'ah*-compliant forms of finance because both profits and losses realised with the invested money are shared between the partners.[142] Contrary to the payment of interest, the return is not fixed in these agreements. Consequently, losses will be borne by all partners, but when the investment yields higher returns, the profits will also be distributed among all partners. These contracts are regarded as (Islamic) equity finance. In Section 3.1 of this chapter I discuss the partnership contracts called *musharaka* and *mudarabah*.

While the partnership contracts provided a *Shari'ah*-compliant alternative for equity finance, a *Shari'ah*-compliant alternative for debt finance was initially lacking. *Shari'ah* scholars revisited traditional sale contracts and leasing contracts to assess whether they could be used as finance contracts. Islamic sale and leasing contracts were used to structure finance transactions. These forms of Islamic finance contracts were permitted by way of exception. Islamic debt finance has the distinguishing element that it is always asset-backed: within an Islamic finance transaction there must always be a direct link to a tangible property due to the prohibition of *riba* (as opposed to conventional finance where money can be traded for money).[143] In the following sections I discuss sale contracts such as *murabaha*, *salam* and *istisna'* (Section 3.2) and leasing contracts such as *ijarah* and *ijarah wa-iqtina* (Section 3.3).

Shari'ah scholars revisited traditional sale and leasing contracts to use them as finance contracts so that they could stay close to what already existed in Islamic jurisprudence, since much was already written on these contracts

142 Usmani 2002, p. xv.
143 *Ibid.*, pp. xiv-xvii.

in *fiqh* books. As discussed in Chapter 1, during the period of European colonial empires the development of Islamic jurisprudence came to a standstill because the laws of the European colonial empires replaced Islamic law in most of the colonised jurisdictions.[144] After the emergence of Islamic finance in the second half of the 20th century, *Shari'ah* scholars tried to develop new rules, while adhering to what already existed in Islamic jurisprudence.

3.1 Partnership Contracts: *Musharaka* and *Mudarabah*

The most well-known partnership contracts are the *musharaka* and the *mudarabah*. The *musharaka* is a form of partnership where all partners contribute capital to the partnership and all partners have an equal right to the management of the partnership. It is often referred to as an Islamic joint venture.

> The *muzara'a*, *musaqa* and *mugharasa* are forms of partnership contracts that can be used for the agricultural sector. Due to resemblance in their main characteristics to a *musharaka*, these contracts will not be discussed in further detail. Furthermore, the contract of *wakalah*, although originally a contract of agency instead of a partnership contract, shows many resemblances with partnership contracts such as the *musharaka* and the *mudarabah*. The most important difference is that the agent receives a fixed agency fee in a *wakalah* contract, instead of (part of) the realised profits. The *wakalah* is also not discussed in futher detail.

In the *mudarabah* contract one partner participates through the contribution of capital without having any responsibilities for the management of the partnership (the silent partner), while the other partner participates through his labour and expertise and is responsible for the management of the partnership. The *mudarabah* contract is in essence comparable to a Dutch limited partnership (*commanditaire vennootschap*) with general partners (*beherende vennoten*) and silent partners (*commanditaire vennoten*).

> The contract of *mudarabah*, also referred to as *muqaradah* or *qirad*, shows many similarities to the medieval *commenda* contract used in Italy. Some academics have argued that the *commenda* contract originated from the Islamic *mudarabah* contract.[145] If that were to be the case, then the *mudarabah* contract may have indirectly contributed to the development of the Dutch limited partnership because

144 *See* Section 1.1.1 of Chapter 1.

145 *See* Udovitch 1962; Udovitch 1970; Udovitch *(Islam and the trade of Asia: A Colloquium)* 1970; Pryor 1977; Cizakca 1996.

the Italian *commenda* contract is generally regarded as a main source of the Dutch limited partnership.

The Islamic finance rules for both *musharaka* and *mudarabah* will be discussed in more detail below (Subsections 3.1.1 and 3.1.2). As a starting point, these partnerships are in contractual form. In the last subsection of this section the possibility to give the *musharaka* legal personality will be discussed (Subsection 3.1.3).

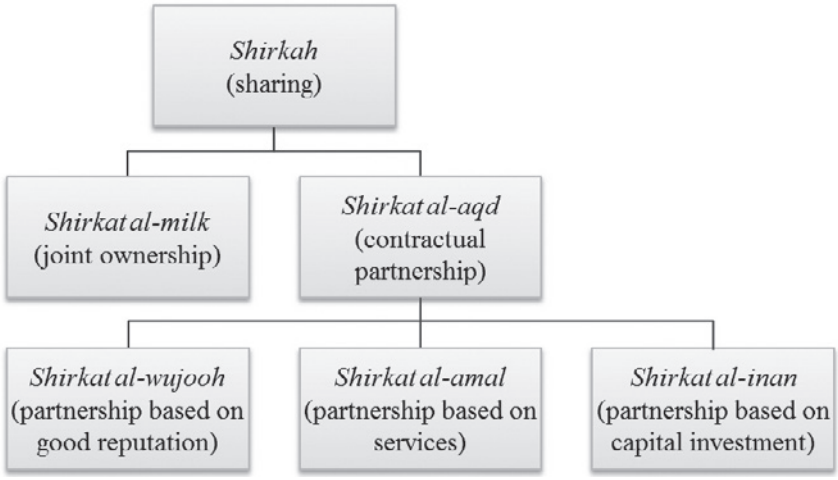
3.1.1 *Musharaka*

The word *musharaka* originally derived from the Arabic word *shirkah*, which means 'sharing'.[146] The term *shirkah* has a much wider scope than *musharaka*; *musharaka* is only a specific form of *shirkah*.[147] Within the terminology of Islamic jurisprudence, *shirkah* has been divided into two categories: the *shirkat al-milk* (literally 'sharing in ownership') and the *shirkat al-aqd* (literally 'sharing by contract').[148] *Shirkat al-milk* refers to joint ownership of property by at least two persons.[149] *Shirkat al-aqd* refers to a partnership in business effected through a contract.[150] The term *musharaka* refers only to the *shirkat al-aqd*.

The *shirkat al-aqd* is further divided into three categories: the *shirkat al-wujooh* (partnership based on good reputation in the market), the *shirkat al-amal* (partnership based on services) and the *shirkat al-inan* (partnership based on capital investment).[151] Figure 1 provides an overview of the different forms of *shirkah*. Within Islamic finance, the *musharaka* is often structured as the *shirkat al-inan*. Therefore, in this research the *musharaka* will be explained through a study of the *shirkat al-inan*. AAOIFI SS 12 is used to discuss the Islamic finance rules for *musharaka*.

146 Usmani 2002, p. 5; Thomas & Thofeek (*Structuring Islamic Finance Transactions*) 2005, p. 53; Elfakhani, Zbib & Ahmed (*Handbook of Islamic Banking*) 2007, p. 120; Rammal 2004, p. 3.
147 Usmani 2002, pp. 5-6; Iqbal & Mirakhor 2006, pp. 91-93.
148 Usmani 2002, pp. 5-6; Thani, Abdullah & Hassan 2003, pp. 53-54; Jabbar 2009b, pp. 178-179.
149 Usmani 2002, pp. 5-6; Thomas & Thofeek (*Structuring Islamic Finance Transactions*) 2005, p. 53; Elfakhani, Zbib & Ahmed (*Handbook of Islamic Banking*) 2007, p. 120; Thani, Abdullah & Hassan 2003, pp. 53-54; Jabbar 2009b, pp. 178-179.
150 *Ibid*.
151 Usmani 2002, pp. 5-6; Thomas & Thofeek (*Structuring Islamic Finance Transactions*) 2005, p. 53; Thani, Abdullah & Hassan 2003, pp. 53-54; Jabbar 2009b, pp. 178-179.

Figure 1 Overview of legal forms of *shirkah*



A *musharaka* can be created by parties through a contract or through the incorporation of a stock company (*kapitaalvennootschap*).[152] It can be concluded with non-Muslims and conventional banks, as long as the partnership does not serve non–*Shari'ah*-compliant purposes.[153] The objects of the *musharaka* should be clearly defined in either the *musharaka* contract or the articles of association of the *musharaka*, depending on whether the *musharaka* is created by the conclusion of a contract or through the incorporation of a stock company.[154]

Each partner (*sharik*) contributes capital to the *musharaka*.[155] The *musharaka* contract should have a clause specifying the manner of profit-sharing between the partners.[156] The manner of profit-sharing should be such that the partners will receive a percentage of the actual profit.[157] They are not allowed to receive a lump sum or a percentage of their invested capital.[158] One of the cornerstones

152 For more on the *musharaka* as a stock company, see Section 3.1.3 of this chapter.
153 Arts. 3/1/1/2 and 3/1/1/3 AAOIFI SS 12.
154 Art. 3/1/1/1 AAOIFI SS 12.
155 Art. 3/1/2/1 AAOIFI SS 12. According to this article, the capital contribution can be in cash and/or in kind. There has been debate in the *fiqh* literature on the nature of the capital invested in the *musharaka*, but the contemporary Islamic scholars agreed that capital contribution both in cash and in kind are permissible, *see* Usmani 2002, pp. 8-10.
156 Art. 3/1/5/1 AAOIFI SS 12.
157 *Ibid.*
158 Arts. 3/1/5/1 and 3/1/5/8 AAOIFI SS 12.

of the *musharaka* contract is its profit-and-loss-sharing characteristic.[159] Any clause that may result in a violation of the principle of profit-and-loss-sharing renders the entire *musharaka* contract void under Islamic finance law.[160]

As a starting point, all partners have an equal right to the management of the *musharaka*.[161] The partners can also appoint a third party or one of the partners as the manager of the *musharaka*.[162] If one of the partners is appointed as the manager, he may receive a greater share of the profit than the profit he would have received based solely on his share in the partnership.[163]

The liability of the partners of the *musharaka* can be divided into the internal liability of the partners and their external liability. Their internal liability relates to the question whether the partners are liable towards each other. The external liability of the partners of the *musharaka* deals with the question whether the partners can be held personally liable by creditors of the *musharaka* for debts of the *musharaka* that remain unrecovered from the patrimony of the *musharaka*. Internally, the partners are not liable to each other (not even when they have contractually agreed thereto), except in the case of misconduct, negligence or breach of contract.[164] Externally, however, the liability of the partners is not limited to the amount of their investment in the *musharaka*. The partners are personally liable commensurate with the proportion of their investment for all the debts of the *musharaka*.[165]

Each partner has the right to terminate the *musharaka* contract at any time, after giving notice to the other partners.[166] The partners can also agree that the partnership comes to an end if the agreed upon time or the specified goal of the *musharaka* is reached.[167] When the partnership is liquidated: (i) the liquidation expenses will be paid first; (ii) followed by the financial liabilities of the partnership; (iii) after which the assets of the *musharaka* can be distributed *pro rata* among the partners.[168]

159 In the previous chapter I discussed the importance of profit-and-loss-sharing in Islamic finance transactions as a result of the prohibition of *riba*, *see* Section 2.2.1 of Chapter 2.

160 Art. 3/1/5/7 AAOIFI SS 12. The article only refers to profit-sharing, but due to the prohibition of *riba*, it seems more appropriate to me that both profit- and loss-sharing are meant to be covered by this article.

161 Art. 3/1/3/1 AAOIFI SS 12.

162 Arts. 3/1/3/2 and 3/1/3/3 AAOIFI SS 12.

163 Art. 3/1/3/4 AAOIFI SS 12.

164 Arts. 3/1/4/1 and 3/1/4/2 AAOIFI SS 12. A third party may provide a guarantee to make up a loss of the capital of (one of) the partners under certain conditions, *see* Art. 3/1/4/3 AAOIFI SS 12.

165 AAOIFI SS 12 does not explicitly discuss the liability of the partners towards third parties, the so called external liability of the partners of the *musharaka*. The external liability of the partners of the *musharaka* has been discussed in the Islamic finance literature. *See* Usmani 2002, pp. 12-13; Thani, Abdullah & Hassan 2003, pp. 54-56; Visser 2009, pp. 55-57.

166 Art. 3/1/6/1 AAOIFI SS 12.

167 *Ibid*.

168 *Ibid*.

3.1.2 *Mudarabah*

AAOIFI SS 13 discusses the *Shari'ah* rules applicable to the *mudarabah* contract. As a starting point, the *musharaka* contract and the *mudarabah* contract show many similarities and the rules discussed above are similar for the *mudarabah* contract. Like a *musharaka* contract, profits will be distributed among the partners based upon an agreed percentage of the actual profit.[169]

> Just like in a *musharaka* contract, the manner of profit-sharing must be specified at the conclusion of the *mudarabaha* contract,[170] one of the partners cannot earn an additional fee,[171] and it is not possible to fix the distributed profit by agreeing on a lump sum or a percentage of the invested capital.[172]

There are, however, also differences between the *musharaka* contract and the *mudarabaha* contract. In a *mudarabah* contract the capital investment is solely from a capital provider (*rab al-maal*) and the entrepreneur who provides his labour (*mudarib*) has the sole right to management, unlike a *musharaka* contract where all partners provide capital and in principle have an equal right to management.[173] Furthermore, unlike a *musharaka* contract, in a *mudarabah* contract the *rab al-maal* bears the losses because the *mudarib* does not invest anything.[174] The *mudarib*, nonetheless, bears the loss of his time, effort and labour in the partnership.[175] In addition, the *mudarib* is personally liable for losses caused by his negligence, misconduct or breach of the *mudarabah* contract.[176]

> It is also possible for the *mudarib* to invest in the *mudarabah*. Once the *mudarib* does so, the *mudarabah* automatically converts into a combination of the *musharaka* and the *mudarabah*: the *mudarib* becomes a partner of his funds (there is a *musharaka* with the *rab al-maal* with regard to the funds of the *mudarib*); and he remains a *mudarib* of the funds of the *rab al-maal* (there is a *mudarabah* with the *rab al-maal* with regard to the funds of the *rab al-maal*).[177]

169 Art. 8/1 AAOIFI SS 13.
170 Arts. 8/1 and 8/3 AAOIFI SS 13.
171 Art. 8/2 AAOIFI SS 12.
172 Art. 8/5 AAOIFI SS 13.
173 Art. 2 AAOIFI SS 13.
174 Art. 8/7 AAOIFI SS 13.
175 AAOIFI SS 13 does not explicitly refer to the losses of the *mudarib*, but this point has been discussed in the Islamic finance literature. *See* Obaidullah 2005, pp. 60; Visser 2009, pp. 54-55; Usmani 2002, pp. 13; Thani, Abdullah & Hassan 2003, pp. 50-52.
176 Art. 4/4 AAOIFI SS 13. *See also* Art. 8/7 AAOIFI SS 13.
177 Art. 8/9 AAOIFI SS 13.

3.1.3 *Musharaka* and *Mudarabah* as Modern Day Corporations

An interesting question is whether the *musharaka* or *mudarabah* can be incorporated as a modern day corporation. There has been debate on the *Shari'ah* compliance of modern day corporations such as stock companies.[178] This debate has revolved mainly around two concepts: (i) the concept of legal personality of corporations; and (ii) the concept of limited liability of shareholders of corporations.[179] Both concepts were new to Islamic law. Initially, there had been questions on their *Shari'ah* compliance due to the possibility of abuse of these concepts through exploitation of creditors of corporations.[180] The acceptance of legal personality of a corporate body means that it can engage in transactions as an independent party having legal capacity, sue parties and be sued and incur its own debts. If the liability of this corporate body exceeds its assets and the corporate body is declared bankrupt, the creditors may lose considerable amounts of their claims.[181] Since the liability of the shareholders is limited to their investment, upon liquidation, the creditors of the corporate body in principle will have no recourse against those shareholders.

After much debate in the *fiqh* literature, the International Islamic *Fiqh* Academy accepted the concept of legal personality of corporations and the concept of limited liability of shareholders of corporations in a resolution (*fatwa*) on financial markets.[182] The AAOIFI also accepted both concepts in AAOIFI SS 12.[183] The ruling of the AAOIFI is mainly based on the *fatwa* of the International Islamic *Fiqh* Academy on financial markets.[184] The main argument of the International Islamic *Fiqh* Academy to accept the limited liability of shareholders was that the creditors of a stock company have knowledge of the limited liability of the shareholders and such awareness on the part of the creditors precludes deception.[185]

AAOIFI SS 12 defines a stock company as a company the capital of which is partitioned into equal units of tradable shares, whereby the liability of each shareholder is limited to his share in the capital.[186] The shareholders are regarded as the co-owners of the stock company. All general rules for the *musharaka* as discussed above are applicable to stock companies, except that

178 This debate is discussed in the following works: Nyazee 1997; Nyazee 1998; Ur Rahman 2010; Foster 2010a; Foster 2010b.
179 Nyazee 1997; Nyazee 1998; Ur Rahman 2010; Foster 2010b, p. 283-288; Usmani 2002, pp. 103-109.
180 Thomas & Thofeek (*Structuring Islamic Finance Transactions*) 2005, p. 46; Usmani 2002, pp. 103-109.
181 Usmani 2002, pp. 103-109.
182 OIC Islamic Fiqh Academy, Res. No. 63 (1/7) 1992.
183 Art. 4 *ff.* AAOIFI SS 12.
184 *See* App. B AAOIFI SS 12.
185 OIC Islamic Fiqh Academy, Res. No. 63 (1/7) 1992.
186 Art. 4/1/1/1 AAOIFI SS 12.

(as appears from its definition): (i) the liability of the partners is limited to their share in the capital of the stock company; and (ii) the stock company has legal personality.[187] Furthermore, there are additional *Shari'ah* rules for stock companies. In addition to AAOIFI SS 12, AAOIFI SS 21 provides rules applicable to shares of corporations.

> Most of the rules for a *Shari'ah*-compliant stock company confirm that a *Shari'ah*-compliant stock company can function in the same way as a conventional stock company: *e.g.* the stock company can issue new shares,[188] shareholders can sell their shares,[189] and shareholders can pledge their shares.[190] In this study I will only focus on the rules that deviate from a conventional stock company and that must be observed to ensure the *Shari'ah* compliance of a stock company.

The rules that must be observed to ensure the *Shari'ah* compliance of a stock company are:

1. a shareholder cannot go short, *i.e.* sell shares that he does not own yet;[191]
2. a shareholder cannot purchase shares using interest-based loans;[192]
3. the stock company cannot issue preference shares, *i.e.* shares that provide shareholders special financial rights that give them priority when profits are distributed;[193] and
4. it is only permissible to trade in shares of a stock company (a) if the main activities of the stock company pertain to tangible properties (as opposed to intangible properties) and (b) the value of the tangible properties and the services of the stock company is not less than 30% of its total assets value.[194]

All four rules relate to *riba* and *gharar*. The first rule that bans short selling relates to *gharar*: in order to avoid uncertainty with regard to the delivery of a property, a seller is not allowed to sell a property that he does not own yet. As discussed in Chapter 2, this is one of the basic rules of Islamic contract law.[195]

187 Arts. 4/1/1/1 and 4/1/1/2 AAOIFI SS 12. Another difference between the *musharaka* contract and the *musharaka* as a stock company is that the latter cannot be unilaterally terminated by one party or a minority of its shareholders, *see* Arts. 4/1/1/1, 4/1/2/1 and 4/1/2/9 AAOIFI SS 12.
188 Art. 4/1/2/3 AAOIFI SS 12.
189 Art. 4/1/2/10 AAOIFI SS 12.
190 Art. 4/1/2/11 AAOIFI SS 12.
191 Art. 4/1/2/7 AAOIFI SS 12; *see also* Art. 3/6 AAOIFI SS 21.
192 Art. 4/1/2/6 AAOIFI SS 12; *see also* Art. 3/5 AAOIFI SS 21.
193 Art. 4/1/2/14 AAOIFI SS 12; *see also* Art. 2/6 AAOIFI SS 21.
194 Art. 3/19 AAOIFI SS 21. It is only permissible to trade in the shares of a stock company that has only intangible properties if the rules for trading in debt claims are taken into account. In essence, this means that the sale must be on-the-spot and for equal values, *see* Art. 3/18 AAOIFI SS 21.
195 *See* Section 2.3.2 of Chapter 2.

The other three rules relate to the prohibition of *riba*. First, a shareholder cannot purchase shares using interest-based loans because of the payment of interest. Second, the issuance of preference shares is not allowed because it violates the concept of profit-and-loss-sharing.[196] Priority shares are, however, permissible because they do not violate the concept of profit-and-loss-sharing.[197] The holders of priority shares have special controlling rights, but they do not have special financial rights. Third, trading in shares of a stock company is only permissible (a) if the main activities of the stock company pertain to tangible properties and (b) the value of the tangible properties and the services of the stock company is not less than 30% of its total assets value. Islamic scholars argue that if the value of the tangible properties and the services of the stock company is less than 30% of its total assets value, the main activities of the stock company do not pertain to tangible properties, even though this may have been stipulated in its objects clause.[198] Shareholders are deemed the owners of the assets of a stock company under Islamic finance law. When selling their shares, they essentially trade the assets of the stock company. These two requirements ensure that they mainly trade in tangible properties when selling their shares. Otherwise, the shareholders will be trading in intangible properties (*bay' al-dayn*), which results in a violation of the prohibition of *riba*.[199] Strictly speaking, services are not tangible properties, but they are added to the percentage of tangible properties if the main activities of the stock company pertain to tangible properties.

3.2 Sale Contracts: *Murabaha*, *Salam* and *Istisna'*

In this paragraph the three sale-based Islamic finance contracts will be discussed. The *murabaha* contract will be addressed first, followed by the contracts of *salam* and *istisna.'*

3.2.1 *Murabaha*

The *murabaha* contract is one of the most frequently used contracts within Islamic finance. According to estimates, 80% of all Islamic finance transactions are structured through *murabaha*.[200] Traditionally, the contract of *murabaha* was a contract of sale with the remarkable feature that the seller

196 Making profit is justified when a commercial risk is taken under Islamic law, *see* Section 2.2.1 of Chapter 2.
197 Art. 4/1/2/14 AAOIFI SS 12; *see also* Art. 2/6 AAOIFI SS 21.
198 *See* App. B AAOIFI SS 12.
199 *See* Section 2.2.1 of Chapter 2.
200 Elfakhani, Zbib & Ahmed (*Handbook of Islamic Banking*) 2007, p. 119.

disclosed the cost price of the property and the profit mark-up.[201] It was not a contract of finance. *Shari'ah* scholars agreed on the use of the contract of *murabaha* for funding purposes by way of exception. Therefore, strict conditions apply to the contract of *murabaha* when it is used for funding purposes. AAOIFI SS 8 provides these rules.

> In the literature and practice, the contract of *murabaha* and the contract of *tawarruq* are often used interchangeably. However, one has to make a distinction between *murabaha* and *tawarruq* (often referred to as a reverse *murabaha* or commodity *murabaha*). In a *tawarruq* contract the party who is in need of funding purchases a tangible property from a financier on a deferred payment basis. The price is often higher than the real value of the tangible property. Next, the party who is in need of funding sells the tangible property to a third party for a lower price (the real value of the tangible property) and this purchase price provides him money instantly.[202] In 2009, the International Islamic *Fiqh* Academy issued a *fatwa* in which it expressly stated that the *tawarruq* is not permissible from a *Shari'ah* perspective.[203] The AAOIFI also issued a new *Shari'ah* Standard on *tawarruq* in 2010, reaching the same conclusion as the Islamic *Fiqh* Academy.[204]

Murabaha can be used only for asset finance purposes.[205] *Murabaha* cannot be used in cases where funding is required for other purposes, such as funding to repay debts of creditors such as suppliers, funding to pay the salary of employees or funding for costs of maintenance of equipment. A party that requires funding to purchase a tangible property can enter into a *murabaha* transaction with a financier. The financier purchases the tangible property and sells it onwards with a profit mark-up to the party that wishes to purchase the tangible property. The latter can pay the purchase price in instalments to the financier. The party from whom the tangible property is bought by the financier should be a third party. It cannot be the ultimate buyer of the tangible property.[206] Otherwise, the transaction results in a sale and buy-back transaction between the financier and the party requiring funding. Such sale and buy-back transaction is called *bay' al-inah*.[207] It is not a *murabaha* transaction.

201 Thani, Abdullah & Hassan 2003, p. 57; Usmani 2002, p. 37; Elfakhani, Zbib & Ahmed (*Handbook of Islamic Banking*) 2007, p. 119; Visser 2009, p. 58; Iqbal & Mirakhor 2006, p. 87; Thomas *et al.* (*Structuring Islamic Finance Transactions*) 2005a, p. 60.

202 For more on *tawarruq*, see Visser 2009, p. 58; Iqbal & Mirakhor 2006, p. 91; Cox & Thomas (*Structuring Islamic Finance Transactions*) 2005, pp. 174-175.

203 *See* OIC Islamic Fiqh Academy, Res. No. 179 (19/5) 2009.

204 *See* Khan 2009, pp. 17-22.

205 Iqbal & Mirakhor 2006, p. 89; Visser 2009, pp. 57-58; Usmani 2002, p. 42.

206 Art. 2/2/3 AAOIFI SS 8.

207 Usmani 2002, p. 43; Visser 2009, p. 69; Thomas *et al.* (*Structuring Islamic Finance Transactions*) 2005a, pp. 70-73.

The *bay' al-inah* is impermissible according to most Islamic scholars because it resembles an interest-bearing loan in their view, which violates the ban on *riba*.[208] Hence, *murabaha* consists of two sales between three different parties: first there is a sale between the third-party seller and the financier, followed by a resale between the financier and the ultimate buyer.

> The profit mark-up in *murabaha* transactions used to be based on interest rates such as LIBOR and EURIBOR. Although there had been much criticism on this point from a *Shari'ah* perspective, the use of interest rates such as LIBOR and EURIBOR was accepted within contemporary Islamic finance because such interest rates only functioned as a benchmark.[209] The Islamic finance industry was looking for a long time for an alternative benchmark. At the end of 2011, the IIBR was introduced as a *Shari'ah*-compliant benchmark for Islamic finance transactions such as the *murabaha*.[210]

> The purchase price (cost price and profit mark-up), the periods of the instalments, and the due date of the payment should be fixed at the moment of the conclusion of the *murabaha* contract. Once the purchase price has been fixed, it cannot increase or decrease anymore because any increase or decrease would be in conflict with the prohibition of *riba*.

The rules of Islamic contract law must be respected throughout the transaction.[211] The third-party seller must be the owner of the tangible property and the tangible property must be in his possession before he enters into the contract of sale with the financier. The legal consequence of a valid contract of sale between the third-party seller and the financier is the immediate transfer of the right of ownership of the tangible property from the third-party seller to the financier. Next, the financier as the owner of the tangible property can enter into the second contract of sale with the ultimate buyer, provided that the tangible property has also been brought under the possession of the financier.[212] In the previous chapter I discussed that under Islamic law a transferee (the financier) can become the owner of a tangible property without the tangible property being delivered to him by the transferor (the third-party seller).[213] However, the financier can only dispose of the tangible property after delivery

208 The *Shari'ah* scholars in Malaysia are, however, an exception to the group of *Shari'ah* scholars prohibiting the *bay' al-inah*. In Malaysia the *bay' al-inah* is accepted, *see* Securities Commission Shariah Advisory Council 2006, pp. 20-22.
209 Art. 4/6 AAOIFI SS 8.
210 *See* IIBR Page on Thomson Reuters; Salah Interview 2011.
211 *See* Section 2.3.2 of Chapter 2.
212 Art. 3/1/1 AAOIFI SS 8.
213 *See* Section 2.3.2 of Chapter 2.

to him. In the *murabaha* transaction the financier should, therefore, also have possession of the tangible property before he enters into the second contract of sale with the ultimate buyer.[214]

The ultimate buyer pays the purchase price (cost price and profit mark-up) to the financier in instalments. The financier may require security to secure the instalment payments from the ultimate buyer. The legal consequence of a valid contract of sale is the immediate transfer of the right of ownership. Therefore, it is not permissible to stipulate that the right of ownership of the tangible property will not be transferred to the ultimate buyer until full payment of the purchase price.[215] However, the ultimate buyer can provide the financier a security right to secure the instalment payments.[216] The security right can only be created once a claim on the ultimate buyer has come into existence.[217] Under Islamic law, a security right can only be granted by the owner of a tangible property.[218] If the security right is granted over the tangible property that is the subject matter of the *murabaha* transaction, a 'fiduciary pledge' can be created.[219] Under Islamic finance law, the term 'fiduciary pledge' in a *murabaha* transaction refers to a security right that is created on a tangible property that is transferred by the financier to the ultimate buyer, whereby the security right for the financier is created from the outset of the transfer of the tangible property.

Furthermore, the parties are permitted to stipulate that the instalments become due and payable before their originally agreed due date in the event of default of or delay in an instalment payment.[220] The parties can also stipulate a penalty clause in the *murabaha* contract, pursuant to which a penalty is charged in the event of default of an instalment payment, provided that the financier pays that amount to a charity.[221] However, the parties cannot stipulate that a rebate will be given to the ultimate buyer in the event of early payment of the purchase price by the ultimate buyer to the financier.[222]

The *murabaha* contract is accepted as *Shari'ah*-compliant for two reasons. First, the financier acquires the ownership of the tangible property and bears the risks attached to ownership during the period that he owns the tangible property.[223] This risk justifies the profit of the financier from a *Shari'ah*

214 Art. 3/2/1 AAOIFI SS 8.
215 Art. 5/4 AAOIFI SS 8.
216 Art. 5/2 AAOIFI SS 8.
217 Usmani 2002, pp. 52-54; Thani, Abdullah & Hassan 2003, pp. 59-61.
218 *Ibid*; Iqbal & Mirakhor 2006, p. 89.
219 Art. 5/2 AAOIFI SS 8.
220 Art. 5/1 AAOIFI SS 8.
221 Art. 5/6 AAOIFI SS 8.
222 Art. 5/9 AAOIFI SS 8.
223 Art. 3/2/2 AAOIFI SS 8.

perspective because of its profit-and-loss-sharing characteristic. In practice, however, both transfers (between the third-party seller and the financier and between the financier and the ultimate buyer) occur simultaneously, mitigating the addressed risk.[224] Nonetheless, *Shari'ah* scholars have accepted this structure as *Shari'ah*-compliant, regardless of how long the financier owns the tangible property. Second, the contracting parties directly trade in a tangible property, making this structure asset-backed. They do not trade in intangible properties: the parties to the *murabaha* do not trade money with money, but they trade money with a tangible property in both transfers (between the third-party seller and the financier and between the financier and the ultimate buyer). Consequently, the prohibition of *riba* is respected.

3.2.2 *Salam*

In the previous chapter I discussed that future sale contracts are invalid under Islamic private law.[225] There are two exceptions to this rule: the contract of *salam* and the contract of *istisna.'*

If a party wishes to sell something he does not own yet, he can enter into a contract of *salam*. Pursuant to the contract of *salam*, a seller undertakes to transfer the right of ownership of a specified and determined tangible property to a buyer at a future specified date in exchange for full payment at the moment of the conclusion of the contract. The seller will receive the required financing and the buyer will probably purchase the tangible property at a lower price than he would have paid in a spot sale. While the price is paid in full, the transfer of the right of ownership of the tangible property is deferred.[226] This contract seems to be the mirror image of the contract of *murabaha*.[227]

Since the contract of *salam* is allowed by way of exception, strict rules must be met to ensure its *Shari'ah* compliance. These rules are documented in AAOIFI SS 10. In this paragraph I will summarise three essential rules. First, the contract of *salam* can only be effected for the sale of fungible goods.[228] Second, the exact date of the transfer of the right of ownership of the goods must be determined.[229] Third, the price must be paid in full at the time of the conclusion of the contract.[230]

224 Thani, Abdullah & Hassan 2003, p. 58.
225 *See* Section 2.3 of Chapter 2.
226 Iqbal & Mirakhor 2006, p. 83; Usmani 2002, p. 84; Thani, Abdullah & Hassan 2003, p. 40.
227 Thomas *et al.* (*Structuring Islamic Finance Transactions*) 2005c, p. 94.
228 Art. 3/2/1 AAOIFI SS 10.
229 Art. 3/2/9 AAOIFI SS 10.
230 Art. 3/1/3 AAOIFI SS 10.

When the contract of *salam* is used as a finance contract, parallel contracts of *salam* are used. A financier enters into a contract of *salam* with a party who requires funding. The financier will pay the amount at that moment so that the party acquires funding. The financier will, however, not be interested in the fungible goods that will be transferred to him at a future date. The financier, therefore, enters into a second contract of *salam* with a third party.[231] This parallel contract of *salam* allows the financier to sell the fungible goods to a third party without having acquired their right of ownership yet. The purchase price of the fungible goods in the parallel contract of *salam* will be higher than the purchase price of the fungible goods in the initial contract of *salam* (and the difference between the purchase prices is the profit that the financier makes in this transaction) because the second contract of *salam* will often be for a shorter period.[232] A strict rule for funding through the use of parallel *salam* is that the second contract of *salam* must not be conditioned upon the first contract of *salam*.[233]

3.2.3 *Istisna'*

Another future sale contract that is permitted by way of exception under Islamic law is the contract of *istisna'*. Under this contract, the seller will manufacture and deliver a specified tangible property to the buyer at a future date.[234] The applicable *Shari'ah* rules for the contract of *istisna'* are documented in AAOIFI SS 11. There are two important rules. First, the contract of *istisna'* can only be effected on commodities that require manufacturing.[235] Second, the purchase price of the commodities must be fixed by the parties.[236] Unlike the contract of *salam*, the full price does not have to be paid in advance: it may be paid in advance, but can also be paid at the end of the period or in instalments as the manufacturing proceeds.[237]

> The contract of *istisna'* is often compared to the contract of *ijarah*. The distinguishing feature between the contract of *istisna'* and the contract of *ijarah* is that

231 The financier is not permitted to sell the fungible goods back to the initial seller because that will result in a sale and buy-back transaction, the so-called *bay'al-inah*. The *bay' al-inah* is prohibited due to its resemblance to *riba, see* Section 3.2.1 of this chapter.
232 Obaidullah 2005, pp. 96-97; Elfakhani, Zbib & Ahmed (*Handbook of Islamic Banking*) 2007, p. 120; Usmani 2002, pp. 86-88; Thani, Abdullah & Hassan 2003, pp. 42-44; Visser 2009, p. 61; Thomas *et al.* (*Structuring Islamic Finance Transactions*) 2005c, pp. 94-96.
233 Art. 6/3 AAOIFI SS 10. *See also* Rule IX of Section 2.3.2 of Chapter 2.
234 Obaidullah 2005, p. 99; Usmani 2002, pp. 88-89; Thani, Abdullah & Hassan 2003, pp. 42-44; Visser 2009, p. 62.
235 Art. 3/1/1 AAOIFI SS 11.
236 Art. 3/2/1 AAOIFI SS 11.
237 Art. 3/2/2 AAOIFI SS 11.

> within the contract of *istisna'* the product is manufactured with the materials of the manufacturer. If the materials belong to the buyer, then the manufacturer is only providing his services to manufacture the product for the buyer through a contract of *ijarah*. If the materials belong to the manufacturer, a contract of *istisna'* is concluded.[238]

The contract of *istisna'* can be adopted for project financing purposes. A financier can enter into a contract of *istisna'* with a client, pursuant to which the financier is obliged to deliver to the client at a future date a product that needs to be manufactured. The client is obliged to pay the financier (possibly in instalments).[239] The financier will not manufacture this product himself. The financier will enter into a parallel contract of *istisna'* with a third party, being a manufacturer or contractor.[240] The financier pays the manufacturer or contractor (possibly instantly). The manufacturer or contractor transfers the product to the financier after it has been manufactured. The financier then transfers it to his client. The profit of the financier is the difference between the prices of the two *istisna'* contracts.[241] The parallel contract of *istisna'* cannot be conditioned upon the initial contract of *istisna'*.[242]

3.3 Leasing Contracts: *Ijarah* and *Ijarah wa-Iqtina*

3.3.1 *Ijarah*

There are two *Shari'ah*-compliant leasing contracts: the *ijarah* and the *ijarah wa-iqtina* (also referred to as the *ijarah muntahia bittamleek*). AAOIFI SS 9 contains the rules applicable to *Shari'ah*-compliant leasing contracts. Pursuant to a contract of *ijarah*, the *manfaa* (right of use) of a tangible property is transferred to a party in consideration of payment. Originally, the contract of *ijarah* was a rental agreement.[243] Like the contracts of sale (*murabaha, salam* and *istisna'*), the contract of *ijarah* has been accepted as a finance contract by way of exception.

238 *See* Usmani 2002, pp. 89-90. Also *cf.* Iqbal & Mirakhor 2006, p. 86; Klarmann 2004, p. 63.
239 Usmani 2002, pp. 90-91; Thani, Abdullah & Hassan 2003, pp. 42-44.
240 Thomas & Kraty (*Structuring Islamic Finance Transactions*) 2005, pp. 102-104; Usmani 2002, pp. 90-91; Thani, Abdullah & Hassan 2003, pp. 42-44; Klarmann 2004, p. 64.
241 Thomas & Kraty (*Structuring Islamic Finance Transactions*) 2005, pp. 103-104; Usmani 2002, pp. 90-91; Thani, Abdullah & Hassan 2003, pp. 42-44; Klarmann 2004, pp. 63-64.
242 Art. 7/4 AAOIFI SS 11.
243 Within conventional finance, leasing contracts are often used as finance instruments for tax reasons. Similarly, within Islamic finance, *ijarah* contracts are used as finance instruments, but for reasons of *Shari'ah* compliance (instead of tax reasons). *See* Usmani 2002, p. 69; Kamali 2007, p. 8; Visser 2009, p. 60; Zaher & Hassan 2001, p. 160; Thani, Abdullah & Hassan 2003, pp. 44-46; Thomas *et al.* (*Structuring Islamic Finance Transactions*) 2005b, p. 77.

The contract of *ijarah* is a contract whereby the owner (lessor) of a tangible property provides the right of use of that tangible property to another person (lessee) for an agreed period at an agreed price.[244] The most significant requirement for a valid *ijarah* contract is that the right of ownership of the tangible property remains with the lessor.[245] As a result of this prerequisite, there are two additional conditions for a valid *ijarah* contract under Islamic finance law. First, the lessor must bear all the liabilities emerging from the ownership of the tangible property, such as taxes referable to the tangible property.[246] The lessee should bear liabilities arising from the use of the tangible property, such as the electricity bill in the case of lease of a machine that runs on electricity.[247] Second, the lessor must also bear all the risks associated with the ownership of the tangible property, such as the risk that the tangible property burns down. The lessee should bear the risks associated with the use of the tangible property.[248] The lessee is also liable to the lessor for damages to the leased property as a result of misuse or negligence on his behalf.[249]

With regard to the terms and conditions of the *ijarah* contract, three conditions must be determined and stipulated in the *ijarah* contract under Islamic finance law. First, the tangible property must be identified and determined in the *ijarah* contract.[250] Second, the lease period must be certain and stipulated in unambiguous terms.[251] The lease period commences on the date of the delivery of the tangible property to the lessee, regardless of whether the lessee starts using the tangible property or not and regardless of the date of the conclusion of the *ijarah* contract. Thus, the *ijarah* contract can be entered into for the lease of a tangible property at a future date. Third, the rental must be determined for the complete lease period.[252] The contracting parties have the freedom to determine the rental according to their wishes.

As with *murabaha* contracts, the use of interest rates such as LIBOR and EURIBOR are also accepted in *ijarah* contracts. Unlike *murabaha* contracts, interest rates are not only permissible as a benchmark according to which the price is fixed, but they can also be used as a floating rental in an *ijarah* contract.[253] In case of floating

244 Iqbal & Mirakhor 2006, pp. 84-85; Thani, Abdullah & Hassan 2003, pp. 46-48; Usmani 2002, pp. 70-71; Visser 2009, pp. 60; Thomas *et al.* (*Structuring Islamic Finance Transactions*) 2005b, p. 78.
245 Art. 3/1 AAOIFI SS 9. The lessee of a tangible property is allowed to sub-lease the leased property to the lessor or a third party under Islamic finance law, *see* Arts. 3/3 and 3/4 AAOIFI SS 9.
246 Arts. 5/1/5 and 5/1/7 AAOIFI SS 9.
247 Arts. 5/1/6 and 5/1/7 AAOIFI SS 9.
248 Art. 5/1/8 AAOIFI SS 9.
249 *Ibid.*
250 Art. 5/1/1 AAOIFI SS 9.
251 Art. 4/1/2 AAOIFI SS 9.
252 Art. 5/2 AAOIFI SS 9.
253 Art. 5/2/3 AAOIFI SS 9.

rental, it is necessary that the amount of the rental of the first period is specified and that the rental for the remaining periods is subject to a minimum and maximum ceiling.[254] *Shari'ah* scholars have argued that the use of interest rates in *ijarah* contracts does not mean that interest is charged because the distinguishing element between an *ijarah* contract and an interest-bearing loan is not the amount paid to the lessor. The distinguishing element is that the ownership of the tangible property and its associated risks remain with the lessor: in case of destruction of the tangible property (after which the lessee cannot benefit from it anymore) the lessee is not bound to pay rental nor will the lessor receive rental, while in the case of an interest-bearing loan the lender will receive interest.[255] Nonetheless, with the introduction of the Islamic benchmark IIBR at the end of 2011, an alternative benchmark has been introduced in the Islamic finance market to replace interest rates such as LIBOR and EURIBOR in Islamic finance transactions such as the *ijarah*.

3.3.2 *Ijarah wa-Iqtina*

The *ijarah wa-iqtina* is a leasing arrangement that consists of an *ijarah* contract and an additional binding promise of the lessor to the lessee, pursuant to which the lessor promises to transfer the ownership of the tangible property to the lessee at the end of the lease period. The *ijarah wa-iqtina* shows similarities to a conventional financial lease.

Three rules should be observed while structuring an *ijarah wa-iqtina*. First, the contract of *ijarah* grants the lessee solely the right of use of a tangible property. The transfer of the right of ownership of the tangible property is not possible with such contract.[256] A separate contract of sale must be entered into between the parties in order to transfer the right of ownership.[257] The legal consequence of a validly concluded contract of sale is the immediate transfer of the right of ownership, so the contract of sale must be concluded at the time when the parties wish to transfer the right of ownership of the tangible property (often at the end of the lease period). Second, the *ijarah* contract cannot contain any conditions with regard to the contract of sale because of the rule of Islamic contract law that a transaction cannot be conditioned upon another transaction.[258] Third, in order to provide the lessee certainty that the lessor will enter into the contract of sale at the end of the lease period, the lessor can promise to sell the tangible property or give it as a gift after the last lease

254 Art. 5/2/3 AAOIFI SS 9.
255 *See* Iqbal & Mirakhor 2006, pp. 84-85; Usmani 2002, pp. 75-77.
256 Art. 8/3 AAOIFI SS 9.
257 Arts. 8/1 and 8/3 AAOIFI SS 9.
258 *See* Rule IX of Section 2.3.2 of Chapter 2.

payment.[259] Such binding promise is called a *wa'd*.[260] The binding promise cannot be a bilateral promise because that will result in a future sale contract. A future sale contract is invalid under Islamic contract law.[261]

3.4 Concluding Remarks

In this chapter Islamic finance contracts were discussed. The rules of Islamic private law, as described in the previous chapter, determine the framework for the rules applicable to Islamic finance contracts. The contracts can be divided into three categories: equity-based, sale-based and lease-based.

The prototype equity-based Islamic finance contract is the *musharaka*. The *musharaka* is a partnership, whereby all partners contribute capital to the partnership and all partners have an equal right to its management (unless one of them is appointed as manager). The profits of the partnership are shared according to an agreed upon percentage of the actual profit and losses are borne by the partners commensurate with the proportion of their investment. The *musharaka* can also be created through the incorporation of a *musharak* stock company.

The prototype sale-based Islamic finance transaction is the *murabaha*, where a tangible property is sold and transferred by a third-party seller to the financier, followed by its resale and transfer by the financier to the ultimate buyer. The purchase price of the second sale consists of the cost price of the tangible property (*i.e.* the sale price of the first sale) and a profit mark-up. The ultimate buyer can pay the purchase price in instalments to the financier.

The *ijarah* contract is the prototype lease-based Islamic finance contract. Pursuant to the *ijarah* contract, the owner of a tangible property (lessor) leases it to another party (lessee) for an agreed period at an agreed price. The lessor bears the risks and liabilities attached to the ownership of the tangible property, while the lessee bears the risks and liabilities that are attached to its use.

Sukuk transactions are structured on the basis of the Islamic finance contracts that were discussed in this chapter. For the structuring of *sukuk* in the next chapter, I will focus on the prototype contract of each category: the *musharaka*, the *murabaha* and the *ijarah*.

259 Art. 8/1 AAOIFI SS 9.
260 The *wa'd* is discussed in more detail in Section 2.3.2 of Chapter 2.
261 Art. 8/2 AAOIFI SS 9.

4 *Sukuk*

In this chapter I create a legal framework for *sukuk* structures that should be taken into consideration when structuring *sukuk* under Dutch private law as will be discussed in the subsequent chapters. Before doing so, an understanding of *sukuk* is required. I will discuss the origins of *sukuk* and its position as Islamic securities in financial markets.[262] Next, I will discuss a securitisation process called *tawreeq*. The ownership of the underlying property in a *sukuk* transaction is transferred to the *sukuk* holders through the use of *tawreeq*. Each *sukuk* transaction is structured on the basis of one of the Islamic finance contracts that were discussed in Chapter 3. I will discuss the legal structure of three types of *sukuk*: the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah*. Based on the Islamic finance rules for *tawreeq* and based on the Islamic finance rules applicable to the underlying Islamic finance contract, I formulate rules that determine the legal framework of each *sukuk* structure.

4.1 *Sukuk*: History and Characteristics

4.1.1 Origins of *Sukuk* in the Middle Ages

The Arabic word *sukuk* is the plural of the word *sakk*, meaning 'certificate' or 'order of payment'.[263] The Muslim societies of the Middle Ages used *sukuk* as papers representing financial obligations arising from trade and other commercial activities.[264] *Sukuk* were written vows to pay for goods when the goods were delivered. They were used to avoid money having to be transported across dangerous terrain.[265]

There is documentary evidence for the use of *sukuk* during the Middle Ages. Such written instruments are encountered frequently in *genizah* documents.[266] *Genizah* documents are documents that were stored in Middle Eastern mosques and synagogues because the word 'God' was written either

262 *See also* Saeed & Salah 2012; Saeed & Salah 2014, pp. 45-47.
263 Khan 2003, p. 163; Hasan & Irfan (*Euromoney Encyclopedia of Debt Finance*) 2006, p. 125.
264 Adam & Thomas 2004, pp. 42-44; Adam & Thomas (*Islamic Asset Management: Forming the Future for Shari'a-Compliant Investment Strategies*) 2004, pp. 73-75; Clifford Chance DIFC Sukuk Guidebook 2009, p. 9; Khan 2003, p. 163.
265 Adam & Thomas 2004, pp. 42-44; Vallely, *The Independent,* 11 March 2006.
266 Udovitch (*The Dawn of Modern Banking*) 1979, pp. 268-274.

in Arabic or Hebrew. Therefore, the merchants of the Middle Ages were reluctant to destroy such documents. The Cairo *genizah* documents contain fragments that indicate the existence of *sukuk* in the 12th century, and these money orders are remarkably similar in form to modern cheques.[267] They state the sum to be paid, the order, the date and the name of the issuer.[268]

> During the third century, banks in Persia and other territories in the Persian Empire also issued letters of credit known as *sakk*. Hence, it is mentioned that the Arabic word *'sakk'* derived from the Persian language.[269] However, the first evidence of *sakk* dates from the Middle Ages.

As a result of the global trade during the Islamic Golden Age,[270] *sukuk* were transported across several countries and spread throughout the world. The Jewish merchants from the Muslim world transmitted such *sukuk* to Europe.[271] An interesting outcome of the trade and transport of *sukuk* is that it functioned as a source of inspiration for the modern day cheque, which was first used in the United Kingdom.[272] The word 'cheque' is derived from the Arabic word '*sakk*'.[273]

4.1.2 *Sukuk*: Islamic Securities in Financial Markets

Today, *sukuk* are known as financial instruments that are traded in capital markets. The entire concept of financial markets is based on the trade in tradable papers that represent financial rights represented by those papers. Usually, securities are divided into shares and bonds. *Sukuk* are Islamic securities with rather distinctive features.

267 Taylor-Schechter Genizah Research Unit (*History in Fragments: A Genizah Centenary Exhibition*).

268 *See genizah* document T-S Ar.30.184 at the Taylor-Schechter Genizah Research Unit (*History in Fragments: A Genizah Centenary Exhibition*).

269 *See* Wright, *Sunday Mirror,* 22 February 2009; Markels, *U.S. News,* 7 April 2008.

270 The Islamic Golden Age refers to a period of time from the eighth century until the 13th century that is marked by contributions of the Islamic world to scientific knowledge, cultural arts, civilisation, commerce and architecture.

271 Braudel 1973, p. 817.

272 English banks started using cheques around the 17th and 18th century in order to counteract the issuance monopoly of the Bank of England. *See* De Vroede 1981, p. 3; Geisweit van der Netten 1892, p. 5.

273 *See* Heck 2006, pp. 217-218; Udovitch (*The Dawn of Modern Banking*) 1979, pp. 268-274; Udovitch (*The Dictionary of the Middle Ages, Vol. 12*) 1989, pp. 105-108. The United Kingdom-based educational project and exhibition exploring the Muslim contributions to building the foundations of Modern Civilisation, called '1001 Inventions: Discover the Muslim Heritage in Our World', also addressed that the word 'cheque' comes from '*sakk*'. *See* 1001 Inventions: Discover the Muslim Heritage in Our World; Vallely, *The Independent,* 11 March 2006.

Conventional shares are generally accepted as *Shari'ah*-complaint under Islamic finance law.[274] From an Islamic finance law perspective, shares are deemed evidence of the ownership of shareholders in the assets of a company.[275] Conventional bonds, on the other hand, are impermissible under Islamic finance law due to the presence of *riba*.[276] The prohibition of *riba* provides two grounds based upon which conventional bonds are impermissible: (i) the prohibition of interest; and (ii) the prohibition of the trade in intangible properties (*bay' al-dayn*). In essence, a conventional bond is an interest-based loan: the bond holders lend an amount (principal) to the issuer, the issuer pays periodic interest to the bond holders and the issuer pays the principal to the bond holders at maturity. A conventional bond represents a debt claim on the issuer. First, the payment of interest, which is the source of the periodic payments in a conventional bond, violates the prohibition of *riba*. Second, the trade in conventional bonds in secondary markets, leading to a trade in debt claims, results in a violation of the prohibition of *riba* due to the doctrine of the *bay' al-dayn*.

Sukuk are the *Shari'ah* substitute for conventional bonds.[277] *Sukuk* are certificates that give *sukuk* holders financial rights and obligations represented by those certificates.[278] The financial rights embodied in *sukuk* are the returns stated in the terms and conditions of the *sukuk*.[279] The returns are generated with underlying *Shari'ah*-compliant transactions. These transactions are structured through the use of the Islamic finance contracts that were discussed in Chapter 3.[280] The returns are paid to the *sukuk* holders. Since the profits generated with the Islamic finance contracts are in line with Islamic law and do not include interest, the use of those contracts ensures that interest payments are avoided in *sukuk* transactions. As a result, the prohibition of *riba* is respected. This is a first distinction between *sukuk* and conventional bonds.

Another difference between *sukuk* and conventional bonds is that *sukuk* should represent the proportionate share of each *sukuk* holder in the ownership of the underlying property that has been made available for investment in the *sukuk* transaction.[281] The trading of *sukuk* is subject to the *Shari'ah* rules that govern the trading of the underlying property that the *sukuk* represents.[282] The prohibition of the *bay' al-dayn* leads to the requirement that *sukuk* holders

274 *See* AAOIFI SS 21; OIC Islamic Fiqh Academy, Res. No. 63 (1/7) 1992.
275 Art. 2/8 AAOIFI SS 21.
276 Art. 5 AAOIFI SS 21.
277 Art. 6 AAOIFI SS 21.
278 Art. 4/1 AAOIFI SS 17.
279 Art. 4/5 AAOIFI SS 17.
280 Art. 4/3 AAOIFI SS 17. Also *cf.* Art. 5/1/1 AAOIFI SS 17.
281 *See* Art. 4/2 AAOIFI SS 17.
282 Art. 4/4 AAOIFI SS 17.

must hold some degree of ownership of a tangible property for the *sukuk* to be tradable in financial markets. Consequently, when the *sukuk* are traded in secondary markets, what is being traded is not (only) a debt claim but (also) (the ownership of) the underlying tangible property. The underlying property can, however, also be an intangible property. The *sukuk* holders will then have a proportionate share in an intangible property. As a result of the *bay' al-dayn*, the *sukuk* can only be transferred at face value, which means that the trade of *sukuk* in secondary markets is obstructed in such case.

4.2 *Sukuk*: A Product of a Securitisation Process Called *Tawreeq*

The AAOIFI issued AAOIFI SS 17 that contains the Islamic finance rules for *sukuk*.[283] The *Shari'ah* rules of AAOIFI SS 17 were not always respected in practice.[284] As a reaction to the developments in the *sukuk* market, the AAOIFI issued a Resolution in February 2008 on *sukuk* referred to as the AAOIFI Resolution.[285] The main target of the criticism of the AAOIFI Resolution was the equity-based *sukuk*.[286] Additionally, disputable elements of other *sukuk* structures, such as the *sukuk al-ijarah,* were also addressed. When structuring *sukuk*, the rules of AAOIFI SS 17 and of the AAOIFI Resolution should be taken into consideration.[287]

Article 2 AAOIFI SS 17 defines *sukuk* as

> *[...] certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity [...].*

283 Art. 6 AAOIFI SS 17.

284 The Islamic finance practice has a hard time translating the general *Shari'ah* rules into specific legal requirements that must be respected under the laws of the jurisdiction that governs the transaction documents, *see* Ali & Salah (*White Paper – Taking Stock and Moving Forward: The State of Islamic Finance and Prospects for the Future*) 2010, pp. 12-13; IMF Policy Discussion Paper 2008, p. 10; IMF Working Paper 2007, p. 27. For more on the tension between an idealist *Shari'ah* approach and the practices of *sukuk* structures, in particular the *sukuk al-mudarabah*, the *sukuk al-ijarah* and the hybrid *sukuk*, *see* Saeed & Salah 2012.

285 Before the issuance of the AAOIFI Resolution, Usmani (a well-known *Shari'ah* scholar and chairman of the AAOIFI *Shari'ah* Board) criticised the developments in the *sukuk* market in a *fatwa* on the contemporary application of *sukuk, see* Usmani 2008. He stated that 85% of all *sukuk* outstanding at that time were not *Shari'ah*-compliant, *see* Arabian Business, *Reuters*, 22 November 2007; Abbas, *Reuters*, 7 June 2008; McSheehy, *Bloomberg*, 13 March 2008.

286 For a discussion of the equity-based *sukuk* structures, more in particular of the *sukuk al-mudarabah* structure before and after the issuance of the AAOIFI Resolution of 2008, *see* Salah 2010b.

287 From a structural perspective, the impact of the AAOIFI Resolution is that the criticised mechanisms of *sukuk* structures from 2003 until 2008 will have limited, if any, precedential value going forward, *see* McMillen 2008, p. 745. For the different structures and mechanisms used in equity-based *sukuk* structures in practice after the issuance of the AAOIFI Resolution, *see* Salah 2010b.

The most significant element in this definition is the ownership of the *sukuk* holders in underlying assets. In the preceding section I discussed how the prohibition of *riba* results in the *Shari'ah* requirement that *sukuk* certificates should represent the proportionate ownership of *sukuk* holders in the underlying property of the transaction. This raises the question how the ownership of an underlying property is transferred to the *sukuk* holders.

4.2.1 Transfer of the Right of Ownership of Tangible Property to *Sukuk* Holders

The issuance of *sukuk* is the result of a securitisation process called *tawreeq*: the ownership of a property is divided into units of equal value and securities (*sukuk*) are issued as per their value.[288] From a *Shari'ah* perspective, the ownership of the *sukuk* holders is not realised through a transfer of proprietary rights under Islamic property law. The *sukuk* holders hold *sukuk* certificates that represent their ownership in the sense that the financial rights and obligations represented by those *sukuk* relate to the returns and losses on the underlying property. Economically, the *sukuk* holders become the owners of the underlying property.

> The view that no transfer of the right of ownership of the property to the *sukuk* holders is required under Islamic property law is supported when studying the legal concept of joint ownership of property (*shirkat al-milk*) under Islamic law, as discussed in chapter 3.[289] Islamic law acknowledges the concept of joint ownership of property, where two or more parties jointly have the right of ownership of property. If the right of ownership of the underlying property were to be transferred to all *sukuk* holders, a joint ownership between the *sukuk* holders would be created under Islamic law. *Sukuk* are, however, not an explication of the legal concept of *shirkat al-milk*.[290] No joint ownership of the underlying property is created between the *sukuk* holders. The *sukuk* holders own the property through a partnership that exists between the *sukuk* holders, whereby they share the profits and losses on the underlying property.[291] The relationship among the *sukuk* holders resembles a contractual partnership (*shirkat al-inan*), where profits and losses are shared.[292] From an Islamic property law perspective, the *sukuk* holders

288 Art. 5/1/2 AAOIFI SS 17; App. D AAOIFI SS 17.
289 *See* Section 3.1.1 of Chapter 3.
290 No reference is made to the *shirkat al-milk* in AAOIFI SS 17. Usmani explicitly stated that *sukuk* are not an explication of the *shirkat al-milk* in his *fatwa* on the contemporary application of *sukuk*, which was a preamble to the AAOIFI Resolution, *see* Usmani 2008.
291 *Cf.* Art. 5/1/5/1 AAOIFI SS 17.
292 *See* Section 3.1.1 of Chapter 3.

do not become the proprietary owners of the underlying property; they only own the property economically.

A comparison can be made with shares. According to Article 2/8 AAOIFI SS 21, shares provide shareholders the ownership of the assets of a stock company. This is the economic reality because the financial benefits and losses that the stock company gains or suffers on the assets are for the shareholders. However, from a legal perspective shares provide shareholders only a bundle of rights: financial rights (*e.g.* rights to dividend) and controlling rights (*e.g.* voting rights). In Chapter 3, I discussed that Islamic finance law has accepted the concept of legal personality for stock companies.[293] A shareholder is not the owner of the assets of a stock company because those assets are owned by the stock company itself. Nonetheless, shareholders are deemed the owners of the assets of a stock company under Islamic finance law. The *Shari'ah* scholars have adopted a substance-over-form approach in this regard: they have looked at the economic reality instead of the legal form of the relationship of the stock company with its shareholders.[294]

4.2.2 The Role of the SPV in the Securitisation Process Called *Tawreeq*

The party requiring funding does not have to transfer the right of ownership of the underlying property to *sukuk* holders. Within the securitisation process called *tawreeq, sukuk* can be issued representing the value of the underlying property to transfer the ownership of the property to the *sukuk* holders economically. This may raise the incorrect impression that the party requiring funding can issue *sukuk* itself to the *sukuk* holders. In the process of *tawreeq*, however, the party requiring funding cannot remain the owner of the underlying property and issue *sukuk* representing the value of that property for two reasons. First, if it remains the owner of the property, it will have control over the property and the right to dispose of the property under Islamic property law. The party requiring funding may act in breach of the terms and conditions of the issued *sukuk* and dispose of the property to other parties. Second, if the party requiring funding remains the owner of the property, the property will form part of its patrimony and its creditors will have recourse to the property under Islamic property law. In the event of its bankruptcy, the property will form part of its bankruptcy estate.

293 *See* Section 3.1.3 of Chapter 3.

294 I do acknowledge that the claim that *Shari'ah* scholars have adopted a substance-over-form approach is controversial, especially due to the fact that Islamic finance has often been criticised for having a form-over-substance approach, *see* Lahlou & Tanega 2007, p. 359-372.

For the reasons mentioned above, the underlying property is transferred by the party requiring funding to an SPV. SPVs fulfil a significant role in the process of *tawreeq*, especially in relation to the transfer of the 'ownership' of the underlying property to *sukuk* holders. The underlying property is transferred by the party requiring funding to an SPV, as a result of which the SPV becomes the owner of the property. The SPV issues *sukuk* certificates representing the value of the underlying property. Consequently, the ownership of the property rests with a separate legal entity that holds the property for the *sukuk* holders. The SPV does not have any other assets and is restricted in its activities. Therefore, *Shari'ah* scholars look through the SPV and regard the transaction as a direct transaction between the party requiring funding and the *sukuk* holders.[295] There is also a separation of the property from the patrimony of the party requiring funding. The creditors of the party requiring funding have no recourse to the property nor will it fall into its bankruptcy estate in case of bankruptcy.

Here another comparison can be made with shares. A joint stock company has legal personality and the company is the legal owner of all the assets in its own legal capacity. This results in a separation of funds: the assets of the joint stock company are separated from the patrimony of other parties because the joint stock company has legal personality. In the same way, in the process of *tawreeq*, the underlying property is separated from the patrimony of the party requiring funding by way of transfer to the SPV. Remarkably, a concept that was criticised from a *Shari'ah* perspective upholds the *Shari'ah* view in *sukuk* transactions: legal personality of a company (the SPV in this case).[296]

In practice, there had been several *sukuk* structures where the legal ownership of the underlying property was not transferred to the SPV.[297] Some *Shari'ah* scholars and academics argued that the *Shari'ah* does not require registration of the transfer of ownership of immovable property in the public registrars.[298] As a result, only the beneficial ownership of the underlying property was transferred to the SPV according to the law of the jurisdiction that governed the *sukuk* transaction documents and the transfer of the right of ownership of the underlying property.[299]

295 The articles in AAOIFI SS 17 refer to *sukuk* transactions as direct transactions between the party requiring funding and the *sukuk* holders. This is, once again, the economic reality of the transactions. SPVs are incorporated solely to legally facilitate the *sukuk* issuance.

296 For more on the debate on the concept of legal personality under the *Shari'ah*, *see* Section 3.1.3 of Chapter 3.

297 *See* Ali & Salah (*White Paper – Taking Stock and Moving Forward: The State of Islamic Finance and Prospects for the Future*) 2010, pp. 12.

298 Adam *(Advances in Islamic Economics and Finance, Volume 1, Proceedings of the 6th International Conference on Islamic Economics and Finance)* 2005, pp. 384-385; Hassan 2008, pp. 3-4.

299 As a result of such practice, an imbalance is created between the *Shari'ah* compliance of a *sukuk* transaction and the legal enforceability of the rights of the *sukuk* holders before the court of a

> The transfer of the right of ownership of immovable property without registration of the transfer in the public registrars results in the transfer of its beneficial ownership (as opposed to legal ownership) only in some jurisdictions. In the Netherlands, there is no split of the right of ownership in legal and beneficial ownership. Consequently, if the transfer of immovable property is not registered in the public registrars, there is no transfer of the right of ownership under Dutch law.[300]

The distinction between legal and beneficial ownership is, however, not known under Islamic property law.[301] Consequently, transferring the beneficial ownership of the underlying property to the SPV is not sufficient. This was also criticised by the AAOIFI in the AAOIFI Resolution.[302] The AAOIFI Resolution states that the *sukuk* holders must own *sukuk* with all the rights and obligations of ownership in the underlying property.[303] In order to realise this through the securitisation process called *tawreeq*, there should be a real transfer of the (legal) ownership of the underlying property from the party requiring funding to the SPV.[304] In the same line of thought, it is also not possible for the party requiring funding to hold the ownership of the underlying property, issue *sukuk* and create only security rights over the property for the *sukuk* holders.

The transaction documents of *sukuk* transactions are often governed by English law in practice.[305] The SPV creates an English law trust through a declaration of trust over the underlying property of the *sukuk* transaction.[306] The SPV (as the trustee) holds the property on trust for the benefit of the *sukuk* holders (as the beneficiaries). The ownership of the trust property is divided into legal ownership and beneficial ownership: the SPV is the legal owner and the *sukuk* holders are the beneficial owners. One of the legal consequences of the creation of a trust under English law is that in the case of bankruptcy of the trustee (SPV) the trust property does not fall into its bankruptcy estate.[307]

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jurisdiction, *see* Ali & Salah (*White Paper – Taking Stock and Moving Forward: The State of Islamic Finance and Prospects for the Future*) 2010, pp. 11-13.

300 *See* Art. 3:84 (1) in conjunction with 3:89 (1) DCC.

301 Usmani Interview 2010; Hassan 2008, p. 3-4. *See also* Section 2.3.1 of Chapter 2.

302 *See* AAOIFI Resolution 2008.

303 Rule 1 AAOIFI Resolution 2008. The wording of this rule might raise the impression that the right of ownership of the underlying property should be transferred from the SPV to the *sukuk* holders. However, Rule 1 AAOIFI Resolution specifically refers to Arts. 2 and 5/1/2 AAOIFI SS 17 on *tawreeq*.

304 McMillen 2008, pp. 741-743; Elgari 2008, pp. 4-6; Yean 2009, pp. 3-8.

305 *Offering Circular* TID Global Sukuk 2006, pp. 61-62; *Offering Circular* JAFZ Sukuk 2007, pp. 75-76; *Offering Circular* NICBM Sukuk 2006, pp. 16-17; *Offering Circular* URC Sukuk 2007, pp. 25-26; *Offering Circular* PETRONAS Global Sukuk 2009, pp. 93-94; *Offering Circular* Qatar Global Sukuk 2003, pp. 14-15; *Offering Circular* DEWA Funding Sukuk 2008, p. 31; *Offering Circular* 1Malaysia Sukuk Global 2010, p. 41.

306 *Ibid*.

307 Hudson 2009a, p. 523; Gardner 2003, p. 248; Abdel-Khaleq & Richardson 2007, pp. 418-419.

This makes English law trusts an attractive legal instrument for *sukuk* transactions. Furthermore, it seems to further substantiate the requirement of the ownership of the *sukuk* holders: the *sukuk* holders acquire the beneficial ownership of the underlying property.

However, the use of English law trusts in *sukuk* transactions does not have a *Shari'ah* background. There is no Islamic finance rule according to which (English law) trusts should be used in *sukuk* transactions. Nor is there an Islamic finance rule according to which the *sukuk* holders should acquire the beneficial ownership of the underlying property. The distinction between legal and beneficial ownership as developed under Equity in English law is unknown under Islamic law.[308] The use of English law trusts in *sukuk* transactions is the result of market practice in financial markets.[309] Consequently, the creation of an English law trust to transfer the beneficial ownership of the underlying property from the SPV to the *sukuk* holders is not necessarily required from a *Shari'ah* perspective. The creation of an English law trust is, nonetheless, an excellent way to secure the position of the *sukuk* holders against a possible bankruptcy of the SPV from a transactional perspective.

> There are several studies with different views on the origins of the English law trust. Some studies have traced the roots of the English law trust to the Islamic legal concept of *waqf*.[310] The *waqf* is a legal concept whereby the ownership of a property is held by a party, while its management or financial benefits are transferred to another party. According to the view taking in these studies, the origin of the trust goes back to the times of the Crusades. Before going off for war, Crusaders used to transfer their land 'on trust' to a friend. Upon return, they had no land, since the friend had become the legal owner of their land as a result of the transfer of the land under Common law. The Crusaders regarded this as unjust and petitioned to the Court of Chancery. Inspired by legal concepts through the contacts with the Middle Eastern and Islamic societies, the Crusaders transmitted the Islamic legal concept of *waqf* to England. Although the English law trust resembles and possibly originated from the Islamic law *waqf*, the use of English law trusts in *sukuk* transactions has no Islamic law background. The Islamic *waqf* is used for religious and charitable purposes and has no connection with *sukuk* transactions.

308 Usmani Interview 2011; Hassan 2008, p. 3-4.

309 Rating agencies have expressed the need for trusts in *sukuk* transactions, *see* Moody's Special Report 2006, p. 6-7. Trusts are also used in other financial transactions such as conventional securitisations, where an SPV creates a trust over its assets (debt receivables which it has purchased from an originator) for the benefit of bond holders.

310 *See* Hudson 2009a, pp. 42-43; Cattan (*Law in the Middle East: Origin and Development of Islamic Law*) 1955, pp. 214-222; Gaudiosi 1988, pp. 1244-1245; Thomas 1949, p. 166; Avini 1996, pp. 1159-1162; Smith 1966, pp. 43-44. *Cf.* Worthington 2006, pp. 63-67; Parker & Mellows/Oakley 2008, pp. 2-3; Hayton & Marshall/Hayton 2001, pp. 9-13; Pettit 2006, pp. 12-15.

Concluding, *sukuk* are *Shari'ah*-compliant securities. These securities should represent the 'economic ownership' of the *sukuk* holders in an identified property. Pursuant to the terms and conditions of the *sukuk*, the *sukuk* holders should acquire financial rights that entitle them to profits realised with the underlying property. This does not mean that the right of ownership of the property should be proprietarily transferred to the *sukuk* holders. The *sukuk* holders only acquire the financial benefits and bear the financial losses of the property, as owners economically do. This is realised through a securitisation process called *tawreeq*, which under Islamic finance law requires:

1. the incorporation of an SPV;
2. the transfer of the right of ownership of the underlying property to the SPV; and
3. the issuance of *sukuk* certificates that economically represent the ownership of the underlying property, that is, the financial rights and obligations represented by the *sukuk* should be based on the returns and losses on the underlying property.

4.3 *Sukuk* Structures

The AAOIFI acknowledges 14 *sukuk* structures.[311] These structures differ significantly and, therefore, they must be studied on a case-by-case basis.[312] The underlying structure of each *sukuk* is determined by one of the Islamic finance contracts that were discussed in the previous chapter.[313] The *sukuk* structures can be categorised into three basic types based on the Islamic finance contract applied in the relevant *sukuk* transaction: equity-based, sale-based and lease-based.[314] In this research the prototype of each *sukuk* structure will be discussed: the *sukuk al-musharaka* (equity-based), the *sukuk al-murabaha* (sale-based) and the *sukuk al-ijarah* (lease-based). In the following three subsections, I will describe the legal structure of these three *sukuk* structures and the applicable Islamic finance rules.

There are in essence three parties in each structure. First, there is a party requiring funding.[315] This party is looking for *Shari'ah*-compliant funding,

311 The 14 *sukuk* structures are *sukuk al-ijarah, sukuk ijarah-mowsufa-bithima, sukuk manfaa-ijarah, sukuk manfaa-ijarah-mowsufa-bithima, sukuk milkiyat-al-khadamt, sukuk al-salam, sukuk al-istisna', sukuk al-murabaha, sukuk al-musharaka, sukuk al-mudarabah, sukuk al-wakalah, sukuk al-muzara'a, sukuk al-musaqa* and *sukuk al-mugharasa*. For more on these structures, *see* Lahlou & Tanega 2007, pp. 367-368.

312 Islamic Finance in the UK: Regulation and Challenges 2007, p. 25.

313 Art. 4/3 AAOIFI SS 17.

314 Dusuki 2009, p. 9.

315 AAOIFI SS 17 refers to this party as the issuer. Strictly speaking, it is not the issuer in the transaction. The *sukuk* certificates are issued by the SPV.

either out of religious beliefs or to attract funding from Islamic investors. It is the party that 'creates or initiates' the transaction and will, therefore, be referred to as the originator.[316] Second, there is an SPV. The SPV is a legal entity incorporated for the sole purpose of facilitating the *sukuk* transaction for the originator. The SPV holds the underlying property and issues the *sukuk*. Third, a group of investors will subscribe to the issued *sukuk*. They are the *sukuk* holders.

4.3.1 Equity-Based *Sukuk*: *Sukuk al-Musharaka*

The first *sukuk* were issued in the early 1980s and mainly structured through equity-based Islamic finance contracts such as the *musharaka* and the *mudarabah*.[317] There are six types of equity-based *sukuk*. Article 3/6 AAOIFI SS 17 defines equity-based *sukuk* as certificates issued with the aim of using the funds for establishing a new project, developing an existing project or financing a business activity on the basis of any of the partnership contracts. The partnership contracts that can be used for equity-based *sukuk* are the *musharaka*, the *mudarabah* and the *wakalah*.[318] In addition, there are three agricultural forms of equity-based *sukuk*: the *sukuk al-muzara'a* (sharecropping certificates),[319] the *sukuk al-musaqa* (irrigation certificates)[320] and the *sukuk al-mugharasa* (agricultural certificates).[321] The focus of this subsection is on the legal structure of the *sukuk al-musharaka* because the *sukuk al-musharaka* provides the basis for all six types of equity-based *sukuk* structures.

The *sukuk al-musharaka* is structured on the basis of the *musharaka* contract.[322] The structure commences with an originator looking for funding. The originator incorporates an SPV for the sole purpose of facilitating the *sukuk* transaction.[323] The SPV has no other assets, nor will it engage in any other

316 This is based on the meaning of the word 'originator' in Oxford Dictionaries Online. The term 'originator' is broadly used in the Islamic finance literature and practice and should not be confused with the term 'originator' as used in conventional securitisation transactions.

317 One of the very first definitions of *sukuk* given in February 1988 during the fourth session of the Council of the Islamic *Fiqh* Academy in Jeddah relates to the *sukuk al-mudarabah*. The Islamic *Fiqh* Academy defines *sukuk* as *"[(...)] investment instruments which allocate the muqaradha capital (mudharaba) by floating certificates, as an evidence of capital ownership, on the basis of shares of equal value, registered in the name of their owners, as joint owners of shares in the venture capital or whatever shape it may take, in proportion to the each one's share therein"*. *See* OIC Islamic Fiqh Academy, Res. No. 30 (5/4) 1988.

318 Strictly speaking, the *wakalah* is not a partnership contract. For more on these partnership contracts, *see* Section 3.1 of Chapter 3.

319 Art. 3/7 AAOIFI SS 17.

320 Art. 3/8 AAOIFI SS 17.

321 Art. 3/9 AAOIFI SS 17.

322 Arts. 3/6/1 and 5/1/5 AAOIFI SS 17.

323 Jabeen & Javed 2007, p. 413.

activities. The originator and the SPV enter into a *musharaka* contract.[324] They both become partners to the *musharaka*. Both partners contribute capital to the *musharaka*. The management of the *musharaka* will be assigned to the originator as the manager of the *musharaka*.

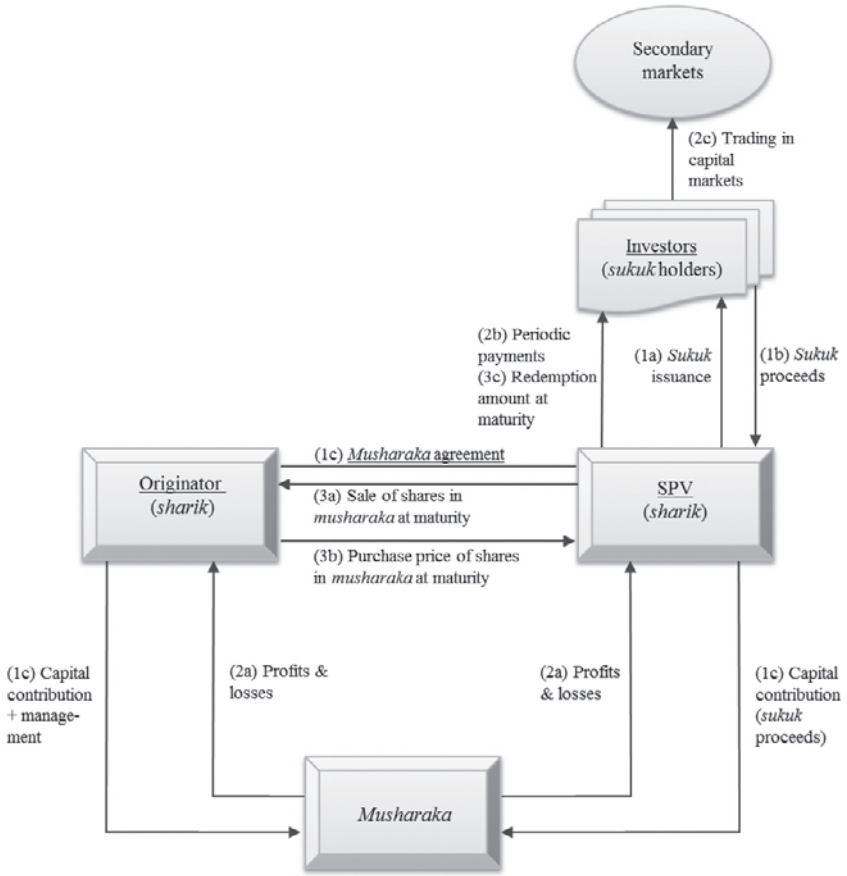
The SPV issues *sukuk* in financial markets. The *sukuk* proceeds are used by the SPV as the capital contribution to the *musharaka*.[325] The SPV holds the equity in the *musharaka*, so the *sukuk* certificates represent 'economic ownership' of *musharaka* equity.[326] Pursuant to the *musharaka* contract, profits and losses of the *musharaka* will be shared between the originator and the SPV. In most *sukuk al-musharaka* structures, a major part of the profit is distributed to the SPV (*e.g.* 90% to the SPV and 10% to the originator). The SPV pays the profits received through to the *sukuk* holders. The profits of the *musharaka* are the sole source of payment of the periodic distribution amounts to the *sukuk* holders. The returns on the *sukuk* are in a form that very much resembles dividends. This also means that no periodic distributions can take place if the *musharaka* is not profitable. Therefore, these *sukuk* are most suitable for investors who want to invest their money for an equity stake.[327]

The profit-and loss-sharing will continue until maturity. During this period, the *sukuk* certificates are tradable in secondary markets.[328] The *sukuk* certificates represent the 'economic ownership' of the *sukuk* holders in the shares held by the SPV in the *musharaka*. The partners in a *musharaka* are regarded as the owners of all the assets of the *musharaka*. Therefore, the *sukuk* holders are deemed to be trading their shares in the assets of the *musharaka* when trading the *sukuk* in secondary markets. As a result, they are not (only) trading in debt claims and the prohibition of *riba* is respected.

At maturity, the originator purchases the shares in the *musharaka* from the SPV. The price paid for these shares to the SPV will be the source of repayment of the principal amount of the *sukuk* holders.[329] The SPV will pay the amount through to the *sukuk* holders after which the *sukuk* will be redeemed. The partnership also comes to an end since the originator will be the sole owner of the company. The originator as the owner of the company may dissolve the company or continue its business activities. Figure 1 provides an overview of the structure of the *sukuk al-musharaka*.

324 Dar Al Istithmar 2006, p. 23.
325 Art. 5/1/5/6 AAOIFI SS 17.
326 Rahman 2003, p. 7.
327 Jabeen & Javed 2007, p. 408.
328 Art. 5/2/16 AAOIFI SS 17.
329 Clifford Chance DIFC Sukuk Guidebook 2009, p. 22.

Figure 1 Structure of *sukuk al-musharaka*



Two further practical aspects of the *sukuk al-musharaka* need to be addressed: (i) its profit-and-loss-sharing characteristic; and (ii) its liability regime. First, the profit-and-loss-sharing characteristic of the *musharaka* gives the *sukuk al-musharaka* an equity feature. The investment in equity is generally regarded as riskier, when compared to investment in fixed income securities, because of the lack of a fixed stream of income. In practice, therefore, two mechanisms were invented to fix the payments to the *sukuk* holders. In the event the profits realised by the *musharaka* were less than the envisaged periodic payments to the *sukuk* holders, the originator would provide interest-free loans to the SPV. The SPV used the amounts to pay the *sukuk* holders in order to fix the periodic distributions to them. The SPV had to repay the loans, but only if it could be recovered by future profits realised by the *musharaka*. There was also a mechanism that fixed the principal of the *sukuk* holders: the originator

provided the SPV a purchase undertaking, pursuant to which it was obliged to purchase the shares held by the SPV at the maturity date of the *sukuk* for a fixed agreed price equal to the principal amount of the *sukuk* holders. Such purchase undertaking is a binding promise called *wa'd* under Islamic law. Both mechanisms are declared impermissible by the AAOIFI Resolution.[330] The reason for the impermissibility is that fixing the payments to the *sukuk* holders (both the periodic distribution amounts and the principal) is contradictory to the concept of profit-and-loss-sharing, which is at the heart of the contract of *musharaka*.[331]

Second, the structure of finance transactions is often determined by tax considerations and the liability of the investors. Tax law falls outside the scope of this study. As a starting point, the partners of a *musharaka* are personally liable commensurate with the proportion of their investment for all the debts of the *musharaka*.[332] This means that the originator and the SPV will be personally liable. In order to mitigate this risk, the parties can structure the *musharaka* through the incorporation of a stock company. The originator and the SPV become the shareholders of the stock company. As discussed in Chapter 3, the liability of the shareholders of a stock company is limited under Islamic law.[333] Therefore, in this study I will treat the *musharaka* in the *sukuk al-musharaka* as a stock company.[334]

From an Islamic finance law perspective, the rules applicable to the contract of *musharaka* should be respected when the *sukuk al-musharaka* is structured. I discussed these rules in Chapter 3.[335] Based on the rules discussed in the previous chapter and the structure of the *sukuk al-musharaka* as discussed in this chapter, I can formulate three Islamic finance rules that should be respected in the *sukuk al-musharaka*:

1. the *musharaka* cannot issue preference shares;[336]
2. the articles of association of the *musharaka* should clearly define its objects;[337] and
3. according to its objects, the main activities of the *musharaka* should pertain to *halal* tangible properties. This rule also leads to the requirement that the value of the tangible properties and the services of the *musharaka*

330 Rules 3 and 4 AAOIFI Resolution 2008. For more on the use of such mechanisms before and after the issuance of the AAOIFI Resolution of 2008, *see* Salah 2010c.
331 *Cf.* Art. 3/1/5/7 AAOIFI SS 12 that states that the contract of *musharaka* cannot contain a clause that may result in a violation of the principle of profit-and-loss-sharing.
332 Usmani 2002, pp. 12-13; Thani, Abdullah & Hassan 2003, pp. 54-56; Visser 2009, pp. 55-57.
333 *See* Section 3.1.3 of Chapter 3.
334 *See* Section 5.1 of Chapter 5.
335 *See* Section 3.1 of Chapter 3.
336 Art. 4/1/2/14 AAOIFI SS 12, *see also* Art. 2/6 AAOIFI SS 21.
337 Art. 3/1/1/1 AAOIFI SS 12.

may not be less than 30% of its total assets value in order for its shares to remain tradable.[338]

4.3.2 Sale-Based *Sukuk*: *Sukuk al-Murabaha*

The sale-based *sukuk* are issued on the basis of sale contracts such as *murabaha*, *salam* or *istisna'*. In this chapter the *sukuk al-murabaha* will be discussed. The *sukuk al-murabaha* is issued on the basis of the *murabaha* contract. Article 3/5 AAOIFI SS 17 defines *sukuk al-murabaha* as certificates of equal value issued for the purpose of financing the purchase of a property.

The *sukuk al-murabaha* commences with an originator looking for funding for the purchase of an identified tangible property from a third-party seller.[339] The tangible property must be for *halal* purposes under Islamic law, that is, a tangible property that is not related to immoral industries (such as the arms, drugs, alcohol, gambling, prostitution and pornography industry).[340] The originator incorporates an SPV that will issue *sukuk* to fund the purchase of the tangible property. The SPV uses the *sukuk* proceeds to pay the purchase price of the tangible property to the third-party seller.[341] The third-party seller transfers the right of ownership of the tangible property to the SPV.[342] At this point, the underlying property in the *sukuk* transaction owned by the SPV is a tangible property and, consequently, the *sukuk* are tradable in secondary markets.[343] This is the only moment when the *sukuk* are tradable in secondary markets.

The SPV resells the tangible property to the originator. The originator pays an amount that includes the cost price plus a profit mark-up to the SPV.[344] The right of ownership of the tangible property is transferred immediately to the originator, while the payment of the purchase price is deferred. The period for which the *sukuk* is outstanding will often be equal to the deferred payment period. The instalments will be paid through by the SPV to the *sukuk* holders.

338 Art. 3/19 AAOIFI SS 21.

339 *Cf.* Art. 5/1/5/5 AAOIFI SS 17 that states that the originator is the seller of the tangible property and the *sukuk* holders are the buyers of the tangible property. The *sukuk* holders as investors in capital markets will, however, not be interested in the purchase of a tangible property. They will sell it onwards and are entitled to its sale price. The originator is often interested in the purchase of a tangible property and will be looking for funding. Therefore, contrary to what is mentioned in Art. 5/1/5/5 AAOIFI SS 17, the originator will be the party to whom the tangible property is sold eventually. Another party will be the seller of the tangible property to the *sukuk* holders (through an SPV). This does not create any tension with Art. 5/1/5/5 AAOIFI SS 17 because the essence of that article is that the economic ownership of the tangible property is sold to the *sukuk* holders, making them temporarily the economic owners of the tangible property.

340 *See* Section 2.2 of Chapter 2.

341 Ramadili, Hassan & Adesina-Uthman 2010, p. 8.

342 Adam & Thomas 2004, pp. 131-133.

343 Art. 5/2/15 AAOIFI SS 17.

344 Dar Al Istithmar 2006, p. 20.

The SPV has a claim on the originator for the payment of the purchase price, which is the underlying property of the *sukuk* transaction at this point. After delivery of the tangible property to the originator, the *sukuk al-murabaha* are not tradable anymore.[345] In practice, both sale contracts (between the third-party seller and the SPV and between the SPV and the originator) are signed simultaneously. Consequently, the *sukuk al-murabaha* is not tradable.[346] Since the SPV has only a contractual claim for the payment of the purchase price on the originator, it will require security for the payment of the purchase price. The originator will grant the SPV a security right over the tangible property to secure its payment obligations.

The SPV pays the instalments to the *sukuk* holders. This can be structured in different ways. The *sukuk* can be redeemable securities, which means that the deferred payments will be paid through to the *sukuk* holders redeeming the *sukuk* over time.[347] With the payment of the last period, the *sukuk* are completely redeemed. It is, however, also possible to create a reserve account and pay the *sukuk* holders the profit mark-up over the underlying tangible property periodically, while the cost price of the tangible property will be kept in the reserve account. At the maturity date of the *sukuk*, the funds held in the reserve account will be paid to the *sukuk* holders to redeem the *sukuk*. Another possibility is that the entire amount will be paid through to the *sukuk* holders at the maturity date of the *sukuk*. This turns the *sukuk* into a non-coupon security comparable to a zero coupon bond.[348] However, contrary to a zero coupon bond where a debt claim is sold at discount, in a *sukuk* transaction profit is made through trade in a tangible property.[349] The originator can decide what kind of *sukuk al-murabaha* it would like to offer. Figure 2 gives an overview of this structure.

345 Art. 5/2/15 AAOIFI SS 17.

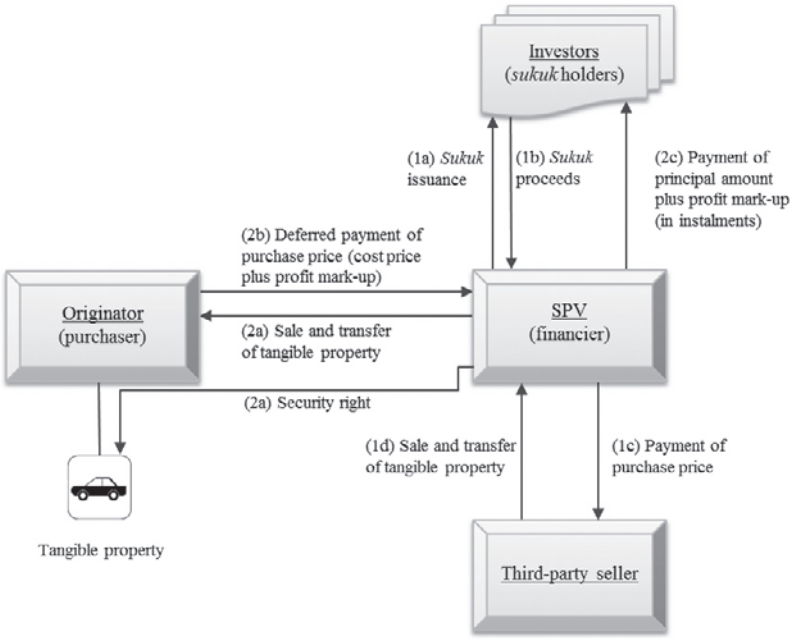
346 The AAOIFI Resolution reconfirmed that *sukuk* must not represent debts or receivables in order to be tradable, *see* Rule 2 AAOIFI Resolution 2008.

347 From a *Shari'ah* perspective, the redeemable feature of *sukuk* does not create any tension with Islamic law because the *sukuk* will be redeemed for their face value over time, which is permissible according to Art. 5/2/1 AAOIFI SS 17.

348 Al-Amine 2001, p. 3.

349 Zero coupon bonds are impermissible under Islamic finance law because the bonds are sold at discount. This results in a prohibition of *riba* because intangible properties are traded not for their face value, but with a decrease in value.

Figure 2 Structure of *sukuk al-murabaha*



On the basis of the rules for the *murabaha* that were discussed in Chapter 3, I can formulate the Islamic finance law rules applicable to the *sukuk al-murabaha*:

1. the third-party seller should be the owner of the tangible property and possess it before the conclusion of the contract of sale with the SPV;
2. subsequently, the SPV should be the owner of the tangible property and possess it before the conclusion of the contract of sale with the originator;[350]
3. the SPV and the originator may not stipulate that the ownership of the tangible property is not transferred to the originator until full payment of the purchase price to the SPV;[351]
4. the originator may grant a security right only once the originator has incurred a debt for which the security will be granted;
5. the originator may grant a security right only over a tangible property it owns and possesses. If the security right is granted over the subject matter of the *murabaha* transaction, the originator and the SPV can agree on a 'fiduciary pledge', *i.e.* a security right that is granted to the SPV from the

350 Art. 3/1/1 AAOIFI SS 8.
351 Art. 5/4 AAOIFI SS 8.

outset of the transfer on the tangible property that is the subject matter of the transfer;[352]

6. the SPV and the originator may not stipulate that a rebate will be given to the originator in the event of early payment of the purchase price by the originator to the SPV;[353] and
7. the SPV and the originator may stipulate a penalty clause in the contract of sale between them, pursuant to which a penalty is charged in the event of default on an instalment, provided that the SPV pays that amount to a charity.[354]

4.3.3 Lease-Based *Sukuk*: *Sukuk al-Ijarah*

Lease-based *sukuk* are one of the most popular *sukuk* because they can offer fixed returns to *sukuk* holders (as the *sukuk al-murabaha*) and are tradable at the same time (as the *sukuk al-musharaka*), having the benefits of both the other two categories of *sukuk*. These two features also make lease-based *sukuk* a compatible alternative to conventional bonds.[355] These *sukuk* are attractive for investors looking for *Shari'ah*-compliant fixed income securities.[356] The contract of *ijarah* forms the basis of lease-based *sukuk*. Tangible property that is eligible for leasing such as land, building, aircraft, vehicles or equipment can be used as the underlying property of the *sukuk* transaction.[357]

There are five forms of lease-based *sukuk*. Article 3 AAOIFI SS 17 subcategorises the five different forms of lease-based *sukuk* in two categories: (i) *sukuk* certificates representing ownership in a (leased) tangible property (*sukuk al-ijarah*); and (ii) *sukuk* certificates representing the right of use of a tangible property (*sukuk manfaa-ijarah*). The *sukuk manfaa-ijarah* is, in turn, subdivided into four different types, namely, *sukuk* representing: (a) the right of use of an existing tangible property; (b) the right of use of an identified future tangible property; (c) services of a specified party; and (d) identified future services. The *sukuk al-ijarah* will be studied in this research. The *sukuk al-ijarah* is arguably the most flexible *sukuk* structure. It can be structured in several ways. The form of the *sukuk al-ijarah* depends on the nature of the leased property and the purpose of the *sukuk* issuance.[358] The textbook example of

352 Art. 5/2 AAOIFI SS 8.
353 Art. 5/9 AAOIFI SS 8.
354 Art. 5/6 AAOIFI SS 8.
355 Obaidullah 2005, p. 162.
356 Jabeen & Javed 2007, pp. 407-408.
357 Global Investment House Strategy Report 2008, p. 10; Kamali 2007, p. 14; Ayub 2007, pp. 400-401; Tariq & Dar 2007, p. 205; Ramadili, Hassan & Adesina-Uthman 2010, p. 8.
358 The *sukuk al-ijarah* can, for example, be acquired for asset finance purposes, to attract funding for working capital purposes or as a refinancing tool, *see* Al-Amine 2001, p. 5.

the *sukuk al-ijarah* is a *sukuk* issuance over an underlying sale and leaseback transaction.[359] This form of *sukuk al-ijarah* is also studied in this research.

The originator initiates the *sukuk al-ijarah*. The originator must have a tangible property that will be the subject matter of the transaction. The use of the tangible property must be for *halal* purposes. This means that an armoury factory, for example, cannot be the subject matter of the *sukuk* transaction. The office building of a company, on the other hand, qualifies as a *halal* tangible property. The originator incorporates an SPV. The originator sells and transfers the tangible property to the SPV, pursuant to a contract of sale.[360] The SPV becomes the owner of the tangible property.[361] The SPV issues *sukuk* certificates and uses the *sukuk* proceeds to pay the purchase price of the tangible property to the originator.[362]

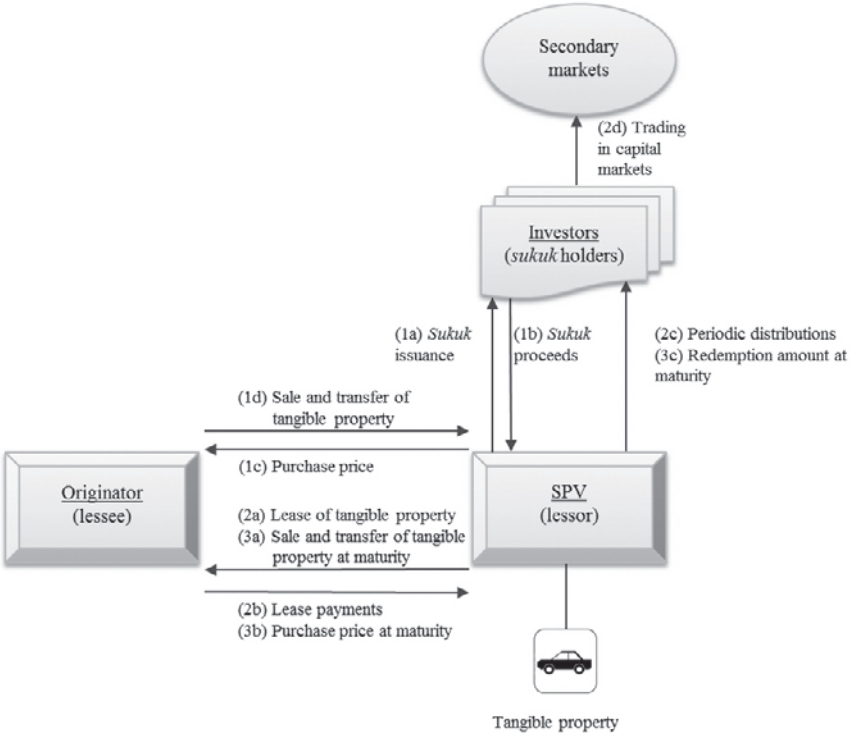
Next, the SPV (lessor) leases the tangible property back to the originator (lessee), pursuant to a separate *ijarah* contract.[363] The originator acquires the right of use of the tangible property and pays rent to the SPV. The SPV pays the rent through to the *sukuk* holders as the periodic distribution amounts of the *sukuk*.[364] The period of the *ijarah* contract will be equal to the period for which the *sukuk* are outstanding. During this period, the *sukuk* can be traded in secondary markets because the underlying property 'owned' by the *sukuk* holders is a (leased) tangible property.[365]

At the maturity date of the *sukuk*, the SPV sells the tangible property back to the originator.[366] The right of ownership of the tangible property is transferred back to the originator and the originator pays a purchase price to the SPV. The SPV pays the purchase price through to the *sukuk* holders. The originator may provide a purchase undertaking to the SPV, pursuant to which the originator is obliged to offer to purchase the tangible property at the maturity date of the *sukuk* for a purchase price that is equal to the principal amount of the *sukuk*. Such purchase undertaking is the binding promise of *wa'd* under Islamic law. The AAOIFI Resolution confirmed that the use of such purchase undertakings is permissible in the *sukuk al-ijarah* structure.[367] After paying back the *sukuk* holders their principal amount, the *sukuk* will be redeemed.[368] Figure 3 provides an overview of the *sukuk al-ijarah* structure.

359 Adam & Thomas 2004, p. 116.
360 *Cf.* Art. 5/1/5/1 AAOIFI SS 17.
361 Wilson 2006, p. 9.
362 *Cf.* Art. 5/1/5/1 AAOIFI SS 17.
363 Dar Al Istithmar 2006, p. 13.
364 Obaidullah 2005, pp. 162-164.
365 Art. 5/2/4 AAOIFI SS 17.
366 McMillen (*Handbook of Islamic Banking*) 2007, pp. 228-229.
367 Rule 5 AAOIFI 2008.
368 McMillen (*Handbook of Islamic Banking*) 2007, pp. 228-229.

The reason for the difference in the approach of *Shari'ah* scholars to the use of the promise of *wa'd* in the *sukuk al-musharaka* and the use of the promise of *wa'd* in the *sukuk al-ijarah* is that the *sukuk al-musharaka* is an equity-based *sukuk* which is based on the concept of profit-and-loss-sharing. A purchase undertaking that guarantees the principal of *sukuk* holders in the *sukuk al-musharaka* is contradictory to the essence of equity-based *sukuk* because it mitigates the (profit- and) loss-sharing between the partners. However, the *sukuk al-ijarah* is based on a lease contract. Guaranteeing the principal of *sukuk* holders in the *sukuk al-ijarah* does not affect the essence of this structure because the concept of profit-and-loss-sharing is not the cornerstone of this structure.

Figure 3 Structure of *sukuk al-ijarah*



From an Islamic finance law perspective, the following five rules should be respected in the *sukuk al-ijarah* structure:

1. the originator should be the owner and the possessor of the tangible property before the conclusion of the contract of sale with the SPV;

2. the SPV should become the owner and the possessor of the tangible property after the conclusion of the contract of sale with the originator;
3. the *ijarah* contract between the SPV and the originator should stipulate that the liabilities and the risks attached to the ownership of the tangible property are borne by the SPV;[369]
4. if a promise of *wa'd* is provided by the originator to offer to purchase the tangible property at the maturity date of the *sukuk*, it may not be a bilateral promise.[370] It should be binding only on the originator; and
5. at the maturity date of the *sukuk*, a new offer and acceptance are required to conclude a new contract of sale between the originator and the SPV.[371] The binding promise may not be an offer.

4.4 Concluding Remarks

In this chapter I discussed the concept of *sukuk* as Islamic securities. Based on the principles of *riba* and *gharar*, these securities should represent the 'ownership' of the *sukuk* holders in an underlying property. Islamic property law does not require the *sukuk* holders to become the owners of the underlying property. The *sukuk* certificates should provide the *sukuk* holders financial rights, according to which they are entitled to the financial benefits realised with the underlying property. Economically, the *sukuk* holders become the owners of the property. Depending on whether the underlying property is tangible or intangible, the *sukuk* certificates can be traded in secondary markets.

The three basic *sukuk* structures were analysed in this chapter: the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah*. In the *sukuk al-musharaka* the originator and the SPV incorporate a *musharaka* partnership, whereby the SPV issues *sukuk* to attract funding for the partnership. In the *sukuk al-murabaha* the originator funds the purchase of a tangible property through an SPV that issues *sukuk* to attract funding for the originator. In the *sukuk al-ijarah* the originator enters into a sale and leaseback transaction with the SPV to acquire funding, whereby the SPV issues *sukuk* to raise money for such funding. On the basis of the Islamic finance rules for each underlying Islamic finance contract and for *sukuk*, I created a framework for the three *sukuk* structures. This framework should be taken into consideration when structuring *sukuk* under Dutch law, as discussed in the subsequent chapters.

369 Arts. 5/1/5, 5/1/7 and 5/1/8 AAOIFI SS 9.
370 Art. 8/2 AAOIFI SS 9.
371 Arts. 8/1 and 8/3 AAOIFI SS 9.

5 Structuring Underlying Islamic Finance Contracts in *Sukuk* Transactions under Dutch Law

In this chapter I assess the underlying Islamic finance contracts (the *musharaka*, the *murabaha* and the *ijarah*) of the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah* under Dutch law in order to answer the question whether these transactions can be structured in a Dutch legal environment. In the previous chapter I formulated specific rules for each *sukuk* structure that should be respected in order to acquire the approval of a *Shari'ah* supervisory board so that the securities qualify as *sukuk* and can be offered as *Shari'ah*-compliant instruments in financial markets. In this chapter I will assess those specific rules for each *sukuk* structure under Dutch law. The Islamic finance rules for the *sukuk al-musharaka* are assessed under Dutch corporate law (Section 5.1). The Islamic finance rules for the *sukuk al-murabaha* (Section 5.2) and the *sukuk al-ijarah* (Section 5.3) are assessed under Dutch property law and Dutch contract law.

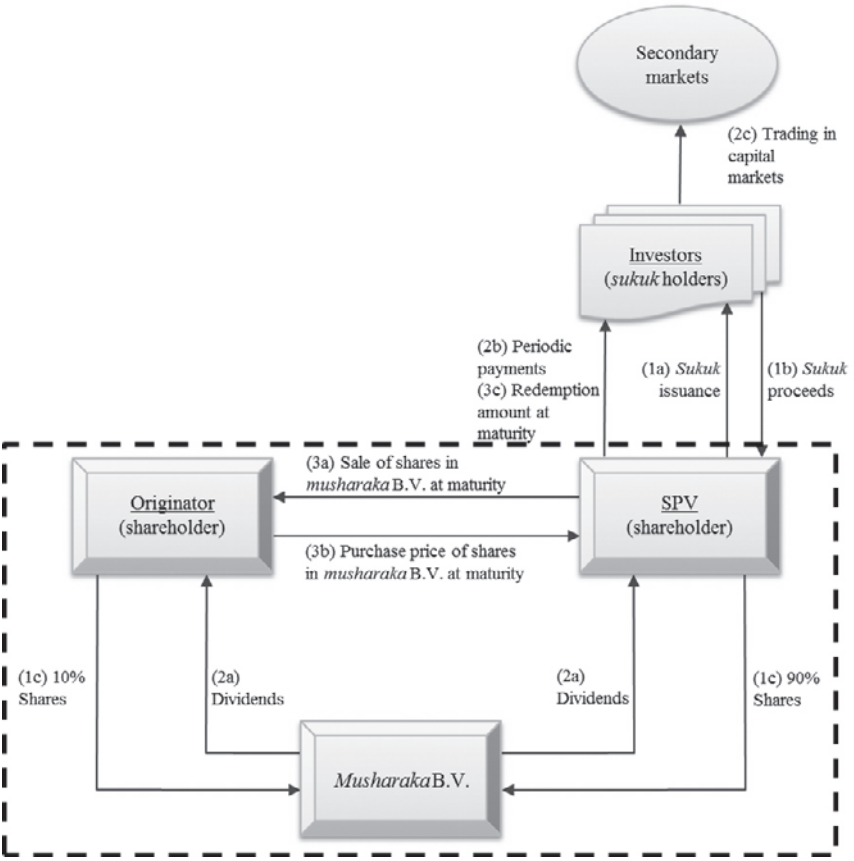
5.1 The *Musharaka* in the *Sukuk al-Musharaka* under Dutch Corporate Law

5.1.1 Islamic Finance Rules for a *Musharaka* Stock Company in *Sukuk al-Musharaka*

In the *sukuk al-musharaka* structure the originator incorporates a *musharaka*. In Chapter 4 I discussed that the *musharaka* in the *sukuk al-musharaka* should be incorporated as a stock company (*kapitaalvennootschap*) instead of a partnership contract in order to limit the liability of the partners of the *musharaka*. The originator and the SPV subscribe to the shares of the *musharaka* and become shareholders of the *musharaka*. The SPV issues *sukuk* certificates and uses the *sukuk* proceeds to pay for the shares of the *musharaka*. During the term of the *sukuk*, the *musharaka* pays dividends to the originator and the SPV as its shareholders. The SPV pays the dividends through to the *sukuk* holders. At maturity of the *sukuk*, the originator purchases the shares of the SPV in the *musharaka* at market value. The SPV pays the purchase price of the shares to the *sukuk* holders. The *sukuk* will be redeemed. In this chapter I discuss only the legal form of the *musharaka* under Dutch law, as marked in Figure 1. I do

not discuss the legal form of the SPV and its legal relationship with the *sukuk* holders; these aspects will be discussed in Chapter 6.

Figure 1 Underlying Islamic finance contract in *sukuk al-musharaka* under Dutch law



In the previous chapter I formulated three Islamic finance law rules for the *sukuk al-musharaka*:

1. the *musharaka* cannot issue preference shares;
2. the articles of association of the *musharaka* should clearly define its objects; and
3. according to its objects, the main activities of the *musharaka* should pertain to *halal* tangible properties. This rule also leads to the requirement that the value of the tangible properties and the services of the *musharaka* may not be less than 30% of its total assets value in order for its shares to remain tradable.

According to Islamic law, these rules must be met in order to qualify the securities as *Shari'ah*-compliant. Otherwise, a *Shari'ah* supervisory board will not approve the structure. These three rules should, therefore, be met under Dutch law when the *sukuk al-musharaka* is structured in a Dutch legal environment. In the next subsection I assess the three Islamic finance rules for the *sukuk al-musharaka* under Dutch corporate law. The first two rules raise no issues under Dutch corporate law. The third rule that requires that the main activities of the *musharaka* should pertain to *halal* tangible assets can also be met easily. The further requirement that the value of the tangible properties and the services of the *musharaka* may not be less than 30% of its total assets value in order for its shares to remain tradable deserves closer consideration.

> Strictly speaking, the term 'tradable' does not refer to the transfer of the shares. This means that the shares can be transferred if the shares are transferred for the same price for which they were purchased initially by the SPV (even when the value of the tangible properties and the services of the *musharaka* is less than 30% of its total assets value). In such case, the shares are not traded, but they are only transferred from an Islamic finance law perspective. However, if the SPV sells and transfers the shares for a lower or higher price than its initial purchase price, the shares are traded. As discussed in chapter 4, the originator and the SPV cannot fix the purchase price of the shares in a *musharaka* in the *sukuk al-musharaka* structure.[372] According to the AAOIFI Resolution of February 2008, it is impermissible to fix the purchase price of the shares because it affects the profit- and loss-sharing characteristic of the *musharaka*. Therefore, the shares should always be sold and transferred at their market value or at a price to be agreed upon at the moment of the sale of the shares, which means that in practice the transfer of the shares will almost always qualify as the trade of the shares from an Islamic finance law perspective.

The tradability of the shares in the *musharaka* is not necessarily required for the structure: the originator and the SPV hold the shares until maturity of the *sukuk*. However, the SPV will sell and transfer its shares at market value at least at maturity of the *sukuk* or earlier in case of an event of default (to use the proceeds to redeem the *sukuk*). Therefore, *Shari'ah* scholars will not approve the *sukuk al-musharaka* structure if the requirement that the value of the tangible properties and the services of the *musharaka* may not be less than 30% of its total assets value in order for its shares to remain tradable is not met. *Shari'ah* scholars have formulated this rule as an additional check to ensure that the requirement that the main activities of the *musharaka* should pertain

372 *See* Section 4.3.1 of Chapter 4.

to tangible properties is not circumvented. Their reasoning is that if the value of the tangible properties and the services of the *musharaka* is not at least 30% of its total assets value, its main activities do not relate to tangible properties even if this is stipulated in its objects.[373] In order to ensure that the prohibition of *riba*, the prohibition of the *bay al-dayn* in particular (which bans the trade in claims), is not violated the shares cannot be traded in such event. Hence, as a starting point, the shares in the *musharaka* are tradable if its main activities pertain to tangible properties. Only at times when the value of the tangible properties and the services of the *musharaka* is less than 30% of its total assets value, its shares may not be traded from an Islamic finance law perspective. I will assess whether this Islamic finance rule can be met through the stipulation of transfer restrictions (*blokkeringsregeling*) in the articles of association of the *musharaka* under Dutch corporate law.

5.1.2 *Musharaka* under Dutch Corporate Law: Incorporation of a *Musharaka* BV

Dutch corporate law distinguishes between two forms of stock companies: a private limited liability company (BV) and a public limited liability company (NV). The *musharaka* in a *sukuk al-musharaka* structure has a closed circle of shareholders: the originator and the SPV. Therefore, I will review the possibilities to structure a *musharaka* through the incorporation of a Dutch BV. I will use the term '*musharaka* BV' when addressing a *musharaka* incorporated as a Dutch BV. Next, I assess whether a BV can be incorporated in such way that it meets the above-formulated Islamic finance rules.

> In this research I study the possibilities to structure a *musharaka* only as a BV under Dutch law.[374] This, however, does not mean that the *musharaka* cannot be structured in other legal forms under Dutch law. It might also be possible to structure the *musharaka* as an NV, as a limited partnership (*commanditaire vennootschap*), as a general partnership (*vennootschap onder firma*) or as a cooperative (*coöperatie*) under Dutch corporate law.[375]

First, the issuance of preference shares is not permitted under Islamic finance law. Preference shares provide shareholders special financial rights as stipulated in the articles of association of a company, for example, priority with regard to payment of dividends. This disrupts the appropriation of profits and

373 *See* App. B AAOIFI SS 21. *See also* Section 3.1.3 of Chapter 3.
374 *See* Section 4.3.1 of Chapter 4 and Section 5.1.1 of this chapter.
375 For more on some of these possibilities, *see* Van Rossum 2009, pp. 360-366.

is not in line with the Islamic concept of profit-and-loss-sharing.[376] Under Dutch corporate law, Article 2:201 (1) DCC attaches equal rights and obligations to all shares of a BV to the proportion of the amount they represent, so long the articles of association do not provide otherwise.[377] So long the articles of association of a *musharaka* BV do not stipulate that it can issue preference shares, such shares will be non-existent.

The second Islamic finance rule for a *musharaka* in a *sukuk al-musharaka* has a counterpart under Dutch corporate law: a notarial deed of incorporation is required for the incorporation of a BV, which, according to Article 2:177 (1) DCC, should contain the articles of association that include the name, the registered office and the objects of the BV.[378] In the *musharaka* BV, its objects should stipulate that the *musharaka* BV is a *Shari'ah*-compliant BV with a short description of the three addressed Islamic finance rules.

The third Islamic finance rule has no counterpart under Dutch corporate law. It can, however, be met easily. The objects of the *musharaka* BV in its articles of association should explicitly limit the activities of the *musharaka* BV to *halal* activities, with a list of prohibited immoral industries which are *haram* and in which it cannot engage. Its objects should, furthermore, stipulate to what tangible properties its main activities pertain. The *musharaka* BV can, for example, be a car manufacturer. It can, however, not be a factoring company or a weapons manufacturer.

Furthermore, the value of the tangible properties and the services of the *musharaka* BV may not be less than 30% of its total assets value.[379] Otherwise, the shares of the *musharaka* BV cannot be tradable from an Islamic law perspective. It is possible to structure this Islamic finance requirement through the stipulation of transfer restrictions in the articles of association of a *musharaka* BV under Dutch law. The originator as its founder should stipulate in the articles of association of the *musharaka* BV that the shares of the *musharaka*

376 *See* Section 3.1.3 of Chapter 3.

377 As the words of Art. 2:201 (1) DCC indicate, the article is a directory provision (*regelend recht*), so it is possible to deviate from it in the articles of association of a BV. The Dutch Supreme Court confirmed this for Art. 2:92 (1) DCC, *see* Dutch Supreme Court 14 December 2007, *NJ* 2008, 105. Art. 2:92 (1) DCC is the counterpart provision for the NV of Art. 2:201 (1) DCC, which is applicable on the BV. As a result, it is possible to issue preference shares under Dutch corporate law, *see also* Huizink 2009, pp. 93-94. Pursuant to Art. 2:201 (3) DCC, it is also possible to issue priority shares under Dutch corporate law. The issuance of priority shares is not conflicting with the *Shari'ah* because priority shares do not disrupt the appropriation of profits, *see* Section 3.1.3 of Chapter 3.

378 Art. 2:175 (2) in conjunction with 2:177 (1) DCC. Dutch law requires that, in addition to the objects of the BV, its name and its registered office should be stipulated in its articles of association, due to the significance of the addressed information for third parties, *see* Pitlo & Raaijmakers 2006, pp. 199-200. Arts. 2:178 and 2:244 (4) DCC contain provisions on other information that must be included in the articles of association of a BV.

379 *See* the third Islamic finance rule for the *sukuk al-musharaka*, as mentioned in Section 5.1.1 of this chapter.

BV are freely transferable as a starting point. It should, furthermore, stipulate that the transfer of the shares is excluded only at times when the value of the tangible properties and the services of the *musharaka* BV is less than 30% of its total assets value based on its annual accounts of that year. In order to operationalise the Islamic finance requirement in practice, the check of the financial ratio may be based on the annual accounts of the *musharaka* BV. As a result, there will be a continuing check of the required financial ratio with the publication of the annual accounts every year. In addition, an accountant can determine the percentage of the tangible properties, but also of the services of the *musharaka* BV by calculating the revenues from the rendering of services.

The articles of association should stipulate that if the financial ratio is not met, the managing board should send a notice to the shareholders that the transfer of the shares is excluded temporarily. The managing board should also register such notice with the shareholders register of the *musharaka* BV and publish it on the website of the *musharaka* BV pursuant to its the articles of association. Once the value of the tangible properties and the services of the *musharaka* BV is over 30% of its total assets value based on its annual accounts of the subsequent year (or possibly earlier based on an interim report of an accountant), the managing board should send another notice to the shareholders stating that the shares can be traded freely again, together with the registration of such notice with the shareholders register and its publication on the website of the *musharaka* BV. According to Article 2:195 (3) DCC, the transfer of the shares of a BV can be excluded temporarily. A transfer of the shares disregarding such exclusion in the articles of association of the *musharaka* BV is invalid under Dutch law.

> A temporary exclusion is not bound by a maximum period. The nature of the business of a BV determines what period is justified. According to the parliamentary history, a temporary exclusion by a period of five years will be in line with the principle of reasonableness and fairness (*redelijkheid en billijkheid*) of article 2:8 DCC, but a longer period, *e.g.* 20 years, can also be justified.[380] The transfer of the shares of a *musharaka* BV in a *sukuk al-musharaka* may not be excluded permanently. The managing board of the *musharaka* BV should ensure that the value of the tangible properties and the services of the *musharaka* BV is at least 30% of its total assets value at the maturity date of the *sukuk*, if not earlier, so that the shares can be transferred by the SPV to the originator at the maturity date. The *sukuk al-musharaka* will be issued for a defined period, which in practice is often five

380 Parliamentary History, Flex BV Law 2012, p. 180.

years.[381] The SPV should be able to transfer its shares in the *musharaka* BV at the maturity date of the *sukuk* so that it has proceeds which it can use to redeem the *sukuk* (*i.e.* the purchase price paid by the originator to the SPV for the purchase of the shares will be paid through by the SPV to the *sukuk* holders to redeem the *sukuk*). If the value of the tangible properties and the services of the *musharaka* BV is not at least 30% of its total assets value at the maturity date of the *sukuk*, the SPV cannot transfer the shares and the *sukuk* cannot be redeemed yet. In practice, it is unlikely that such event will occur because the *musharaka* BV will be a company whose main activities pertain to tangible properties and which, in addition, will take account of the required financial ratio for *Shari'ah* compliance purposes. The articles of association could, however, stipulate that if such unlikely event occurs, the managing board has the obligation to act to the best of its ability to increase the percentage of tangible properties in the *musharaka* BV according to a period defined in its transfer restrictions, *e.g.* six months. The maturity date of the *sukuk* will be extended for that period, *e.g.* six months.

Finally, in order to ensure the *Shari'ah* compliance of the *musharaka* BV not only upon its incorporation but also thereafter, an amendment of the objects and of the transfer restrictions of the *musharaka* BV must be excluded in its articles of association. According to Article 2:231 (1) DCC, these articles can, nevertheless, be amended if all shareholders accept such amendment in a general meeting of shareholders where all subscribed capital is represented. Furthermore, based on Article 2:231 (3) DCC it is also possible to amend the stipulation in the articles of association that excludes the amendment of the objects and of the transfer restrictions of the BV if all shareholders accept such amendment in a general meeting of shareholders where all subscribed capital is represented. As a starting point, the shareholders must refrain from amending the objects and the transfer restrictions of the *musharaka* BV, assuming that they will act in accordance with the articles of association of the *musharaka* BV. If the shareholders, nevertheless, would like to amend the objects or the transfer restrictions of the *musharaka* BV (or the stipulation in its articles of association that excludes their amendment), acceptance of the amendment is required by all shareholders of the *musharaka* BV, including the SPV. The SPV, in turn, must act in the interest of the *sukuk* holders based on its own articles of association. It will, therefore, not accept an amendment of the objects or of the transfer restrictions of the *musharaka* BV that results in a violation of the Islamic finance rules for the *musharaka* BV.

381 *See Offering Circular* TID Global Sukuk 2006, p. 4; *Offering Circular* JAFZ Sukuk 2007, p. 16; *Offering Circular* NICBM Sukuk 2006, p. 5; *Offering Circular* URC Sukuk 2007, p. 8.

5.1.3 Legal Effects and Practical Considerations of Transfer Restrictions in the Articles of Association of the *Musharaka* BV with respect to the Transfer of its Shares and the *Sukuk*

The stipulation of transfer restrictions in the articles of association of the *musharaka* BV is peculiar. In practice, the shares in the *musharaka* BV will not be traded by the originator and the SPV. They will hold the shares during the period when the *sukuk* is outstanding. During this period, the *sukuk* certificates will be traded in secondary markets by the *sukuk* holders. At the maturity of the *sukuk*, the SPV will transfer its shares in the *musharaka* BV to the originator so that it has proceeds which it can use to redeem the *sukuk*. The stipulation of transfer restrictions in the articles of association of the *musharaka* BV is, nonetheless, required to meet the Islamic finance requirement that the value of the tangible properties and the services of the *musharaka* BV may not be less than 30% of its total assets value in order for its shares to remain tradable. This requirement has to be met in order to acquire the approval of a *Shari'ah* supervisory board for the transaction. Article 2:195 (3) DCC makes the implementation of this Islamic finance rule possible under Dutch law.

> On 1 October 2012, the Bill on simpler and more flexible BV law, also referred to as the Flex BV law, entered into force. With the entry into force of the Flex BV law, the statutory provisions relating to transfer restrictions were amended. Under former BV law, there was no possibility for a (temporary) exclusion of the transfer of the shares of a BV.[382] This amendment has been useful in enhancing the *Shari'ah* compliance of a BV.

A transfer of the shares disregarding a temporary exclusion in the articles of association of the *musharaka* BV is invalid according to Article 2:195 (3) DCC. The transfer restrictions have proprietary effects under Dutch law.[383] In case of a right of pledge on the shares of a *musharaka* BV, the pledgee is also bound by the transfer restrictions.[384] So is a bankruptcy trustee in case of bankruptcy of one of the shareholders of the *musharaka* BV. It should, however, be noted that under specific circumstances, for example, in case of bankruptcy, the transfer restrictions in the articles of association of the *musharaka* BV can be set aside

382 *See* former Art. 2:195 (8) DCC.

383 Art. 2:195 (3) DCC. The former Art. 2:195 DCC did not explicitly mention that a transfer of shares disregarding the transfer restrictions in the articles of association of a BV was invalid. However, in the literature it was generally accepted that a transfer of shares disregarding transfer restrictions was invalid based on the former Art. 2:195 (4) and (5) DCC. *See* Asser/Maeijer, Van Solinge & Nieuwe Weme 2010 (2-II*), no. 300; Huizink 2009, pp. 109-112; Van Schilfgaarde/Winter 2009, pp. 130-131; Slagter 2005, pp. 225-226; Kortmann 1991, pp. 282-283; Dortmund 1989, p. 29; Schwarz 1986, p. 23.

384 *See* Art. 2:198 (6) DCC.

by a court.[385] The court will grant such request only if the interests of the petitioner require this and the interests of other parties are not disproportionally prejudiced.[386] If a bankruptcy trustee files such request, the court will consider the interests of the creditors in the bankruptcy and not the interests of the bankruptcy trustee himself.[387] Besides the interest of the petitioner, the court will also consider whether the interests of other parties are not disproportionally prejudiced. According to the parliamentary history, such interests of other parties can be the interests of the shareholders in case of applicability of the transfer restrictions.[388] In the case of the *sukuk al-musharaka*, non-applicability of the transfer restrictions may raise questions on the *Shari'ah* compliance of the (*sukuk al-*) *musharaka*. As a result, unrest may be caused among the *sukuk* holders as investors, which could even result in declaring the *sukuk* due and payable, which affects the SPV as the shareholder of the *musharaka* BV.[389] Although this is a highly casuistic question, there may be good arguments why non-applicability of the transfer restrictions of the *musharaka* BV prejudices the interests of others disproportionally. However, there remains a risk that a court will declare the transfer restrictions non-applicable. The risk addressed is a litigation risk and does not affect the *Shari'ah* compliance of the proposed structure for the *musharaka* upfront, but it only affects its *Shari'ah* compliance once the court has declared the transfer restrictions non-applicable. It illustrates that in case of litigation, the *Shari'ah* compliance of the *sukuk* transaction can be affected. A comparable risk is present with regard to inquiry proceedings (*enquêteprocedure*) at the Enterprise Chamber of the Amsterdam Court of Appeal (*Ondernemingskamer*). The court can declare the transfer restrictions non-applicable by way of immediate injunctions (*onmiddelijke voorzieningen*) if the court reaches the conclusion that there has been failure of policy (*wanbeleid*) within the *musharaka* BV.

The SPV as shareholder in the *musharaka* BV issues *sukuk* to fund its payment for the shares. As addressed, the trade in financial instruments occurs at the level of the *sukuk* and not at the level of the shares in the *musharaka* BV. Consequently, the transfer restrictions in the articles of association of the

385 In the event of bankruptcy, debt managing of natural persons (*schuldsaneringsregeling natuurlijke personen*), right of pledge, attachment in execution (*executoriaal beslag*), issue of bequest (*afgifte van legaat*) or transfer from a community (*toedeling uit een gemeenschap*), the court can declare the transfer restrictions partially or completely non-applicable, see Art. 2:195 (7) DCC.

386 The bankruptcy trustee, administrator, pledgee, execution creditor, interested party by an issue of bequest or interested party by a transfer from a community can file such request with the court according to Art. 2:195 (7) DCC.

387 Parliamentary History, Flex BV Law 2012, p. 191.

388 *Ibid.*

389 Whether the *sukuk* holders can declare the *sukuk* due and payable on the basis of non-*Shari'ah* compliance of the *sukuk* mainly depends on the terms and conditions, in particular the events of default and the remedies, of the *sukuk* as stipulated in its offering circular.

musharaka BV do not affect the tradability of the *sukuk* issued by the SPV. The *sukuk* holders have a legal relationship only with the SPV. The *sukuk* holders can freely transfer their *sukuk* under Dutch law, provided that the terms and conditions of the *sukuk* do not contain transfer restrictions for the transfer of the *sukuk*.[390] This is comparable to the issuance of depositary receipts for shares (*certificering van aandelen*), where transfer restrictions in the articles of association of the BV do not affect the tradability of the depositary receipts issued by the administration office (*stichting administratiekantoor*).[391] As a matter of fact, one of the motives to issue such depositary receipts was formerly to enhance tradability of the shares of a BV because mandatory transfer restrictions used to apply to the transfer of shares of a BV before the entry into force of the Flex BV law. Similar reasoning exists under Islamic law: in the case of *sukuk al-musharaka*, the shares of the *musharaka* cannot be traded when the value of its tangible properties and its services is less than 30% of its total assets value, but the *sukuk* remain tradable in order to create liquidity in secondary markets. This raises no issues under Islamic law. Therefore, the issuance of *sukuk* creates maximum flexibility.

Concluding, the *musharaka* in the *sukuk al-musharaka* can be incorporated as a Dutch BV under Dutch corporate law. In order to ensure that it meets the Islamic finance rules for the *musharaka* in a *sukuk al-musharaka*, its objects should stipulate that the *musharaka* BV is a *Shari'ah*-compliant BV, which means that: (i) it cannot issue preference shares; (ii) its activities are limited to *halal* activites, with a list of prohibited immoral industries which are *haram* and in which it cannot engage; and (iii) its main activities must relate to tangible properties and it will have transfer restrictions. The transfer restrictions should exclude the transfer of the shares when the value of the tangible properties and the services of the *musharaka* BV is less than 30% of its total assets value based on its annual accounts of that year. The possibility to amend the objects clause and the clauses with the transfer restrictions of the *musharaka* BV should be excluded in the articles of association of the *musharaka* BV.

390 The legal relationship between the SPV and the *sukuk* holders and the nature of the *sukuk* are assessed under Dutch law in Chapter 6.

391 Asser/Maeijer, Van Solinge & Nieuwe Weme 2010 (2-II*), nos. 660-661.

5.2 The *Murabaha* in the *Sukuk al-Murabaha* under Dutch Property and Contract Law

5.2.1 Islamic Finance Rules for *Murabaha* Transaction in *Sukuk al-Murabaha*

The *sukuk al-murabaha* is used for asset finance purposes: a party requiring funding for the purchase of a tangible property can use the *sukuk al-murabaha*. This originator incorporates an SPV. The SPV will purchase a *halal* tangible property from a third-party seller. The SPV issues *sukuk* in capital markets. The *sukuk* proceeds are used by the SPV to pay the purchase price of the tangible property to the third-party seller. Next, the SPV sells the tangible property to the originator. The originator pays the initial purchase price plus a profit mark-up to the SPV. This amount is paid in instalments. The SPV pays the amount through to the *sukuk* holders as the periodic distributions and the principal of the *sukuk* certificates.[392] At the maturity date of the *sukuk*, the *sukuk* will be redeemed. In this section, I assess the sale from the third-party seller to the SPV, and the resale from the SPV to the originator under Dutch law, as marked in Figure 2. The legal form of the SPV and its legal relationship with the *sukuk* holders are assessed under Dutch law in Chapter 6.

In Chapters 2 and 3 I discussed the Islamic finance rules for the *murabaha*. On the basis of those rules, I created an Islamic finance framework for the *sukuk al-murabaha* in Chapter 4:

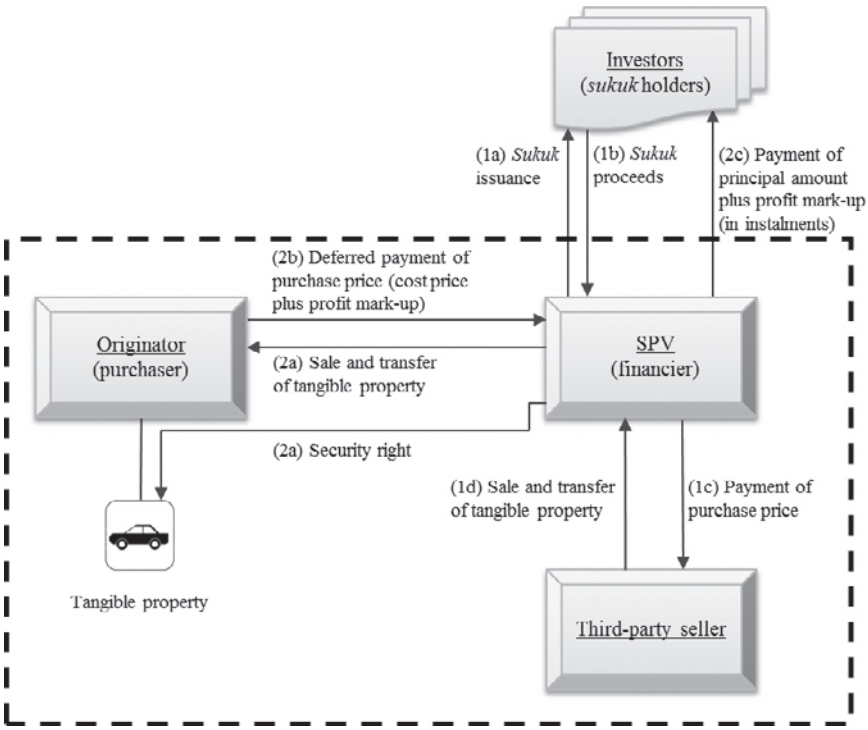
1. the third-party seller should be the owner of the tangible property and possess it before the conclusion of the contract of sale with the SPV;
2. subsequently, the SPV should be the owner of the tangible property and possess it before the conclusion of the contract of sale with the originator;
3. the SPV and the originator may not stipulate that the ownership of the tangible property is not transferred to the originator until full payment of the purchase price to the SPV;
4. the originator may grant a security right only once the originator has incurred a debt for which the security will be granted;
5. the originator may grant a security right only over a tangible property it owns and possesses. If the security right is granted over the subject matter of the *murabaha* transaction, the originator and the SPV can agree on a 'fiduciary pledge', *i.e.* a security right that is granted to the SPV from the

392 The payment of the periodic distributions and the principal to the *sukuk* holders can be structured in different ways, *see* Section 4.3.2 of Chapter 4.

outset of the transfer on the tangible property that is the subject matter of the transfer;[393]

6. the SPV and the originator may not stipulate that a rebate will be given to the originator in the event of early payment of the purchase price by the originator to the SPV; and
7. the SPV and the originator may stipulate a penalty clause in the contract of sale between them, pursuant to which a penalty is charged in the event of default on an instalment, provided that the SPV pays that amount to a charity.

Figure 2 Underlying Islamic finance contract in *sukuk al-murabaha* under Dutch law



These Islamic finance rules should be met in order to structure the *sukuk al-murabaha* in a *Shari'ah*-compliant manner under Dutch law. Otherwise, a *Shari'ah* supervisory board will refrain from approving the structure and the

393 The term 'fiduciary pledge' is mentioned in Art. 5/2 AAOIFI SS 8, *see* Section 3.2.1 of Chapter 3.

securities cannot be offered as *sukuk* in financial markets. As a starting point, I will take the first rule as a given: the following sections are based on the assumption that the third-party seller is the owner and the possessor of the tangible property. The second, third, fourth, and fifth rules will be assessed under Dutch property law (Section 5.2.2). The second and third rules relate to the transfer of the tangible property from the third-party seller to the SPV and its transfer from the SPV to the originator. I will assess how the ownership of the tangible property is transferred and delivered in the *murabaha* transaction under Dutch property law (Section 5.2.2.1). The third, fourth, and fifth Islamic finance rules relate to the creation of security rights to secure the instalments from the originator to the SPV. I will assess the possibilities to secure the instalments from the originator to the SPV in the *murabaha* transaction under Dutch property law (Section 5.2.2.2). The final two rules (sixth and seventh) relate to the treatment of early and late payment of instalments and are assessed under Dutch contract law (Section 5.2.3). The originator and the SPV should ensure that they stipulate these rules as part of the terms and conditions of the contract of sale between them when structuring the *sukuk al-murabaha*. I will assess whether these rules are not conflicting with the provisions of book 7A DCC.

5.2.2 *Sukuk al-Murabaha* under Dutch Property Law

According to the second Islamic finance rule, the SPV should become the owner and the possessor of the tangible property. The conclusion of the contract of sale has the legal effect of an immediate transfer of the ownership of the tangible property under Islamic property law. This leads to the third Islamic finance requirement that the SPV and the originator cannot stipulate that the ownership of the tangible property will be transferred to the originator at a later date (after full payment of the purchase price by the originator to the SPV). The transfer of the ownership of the tangible property from the third-party seller to the SPV does not require the delivery of the tangible property to the SPV under Islamic property law; the conclusion of the contract of sale is sufficient. However, the SPV cannot transfer the ownership of the tangible property to the originator so long the tangible property has not been delivered to it under Islamic property law. This requires the SPV to become the possessor of the tangible property as well. Under Dutch law the transfer of the right of ownership of a tangible property requires its delivery. Therefore, the third-party seller should transfer the right of ownership of the tangible property to the SPV and the SPV should transfer it to the originator under Duch law to meet the second and third Islamic finance rules for the *sukuk al-murabaha* (Section 5.2.2.1).

The third, fourth and fifth Islamic finance rules for the *sukuk al-murabaha* relate to the security right of the SPV for the payment of the purchase price by the originator. As a result of the third Islamic finance rule, the reservation of ownership (*eigendomsvoorbehoud*) is not possible in this structure, although it would be possible in a conventional transaction under Dutch law. The creation of a security right on the tangible property is possible in the *sukuk al-murabaha* structure. The fourth and fifth Islamic finance rules ensure that a security right is created to secure a claim and that the owner of a tangible property creates a security right on it. I will assess how the security right of the SPV can be created under Dutch property law (Section 5.2.2.2).

5.2.2.1 Transfers of Tangible Property under Dutch Property Law

The right of ownership of the tangible property should be transferred by the third-party seller to the SPV, followed by its transfer from the SPV to the originator under Dutch property law. A valid transfer of property must meet the three cumulative requirements of Article 3:84 (1) DCC: (i) delivery (*levering*); (ii) pursuant to a valid title (*geldige titel*); (iii) by the party who has the right to dispose of the property (*beschikkingsbevoegdheid*).

> First, the transfer of the property occurs by the party that has the right to dispose of the property. This Dutch law requirement resembles the Islamic finance rule that (the third-party seller or the SPV as) the transferor should be the owner of the tangible property in order to be able to transfer it to the transferee.[394] Second, there should be a valid title for each transfer.[395] The title for a transfer is the legal basis for the transfer of the property. The title should describe the property in a sufficiently precise manner.[396] In the *murabaha* transaction, the title is the obligation of the third-party seller to transfer the tangible property to the SPV in the first contract of sale and the obligation of the SPV to transfer the tangible property to

394 The Islamic finance rule originates from the principle of *gharar*: one cannot transfer property one does not own yet due to the presence of uncertainty. Dutch property law seems to be in line with the principle of *gharar* at this point. The legal effect of Art. 3:84 (1) DCC and its comparison with Islamic law become even clearer in the case of transfer of non-existing or not-yet-owned property. Art. 3:97 (1) DCC allows the delivery in advance of future property, *i.e.* property that does not exist yet or that the transferor does not own yet. The right of ownership of future property is, however, not transferred to the transferee due to Art. 3:84 (1) DCC until the transferor has acquired its right of ownership. For more on *gharar*, its impact on Islamic property law and a comparison with Dutch property law, *see* Sections 2.2.2, 2.3.1, 2.3.2 and 2.3.3 of Chapter 2.

395 Dutch law has a causal legal system, which means that an invalid title of delivery results in an invalid transfer, *see* Dutch Supreme Court 5 May 1950, *NJ* 1951, 1, with case note by Veegens.

396 *See* Art. 3:84 (2) DCC. The determinability of the property in Art. 3:84 (2) DCC seems to follow from the determinability stated in Art. 6:227 DCC, pursuant to which the contractual obligations of parties should be determinable, *see* Snijders & Rank-Berenschot 2012, pp. 266-267. This requirement under Dutch law resembles the principle of *gharar* under Islamic law, which also requires parties to determine the property being transferred, *see* Sections 2.2.2 and 2.3.2 of Chapter 2.

the originator in the second contract of sale. Third, there should be a valid delivery of the tangible property in both transfers. If the underlying property in the *sukuk* transaction is an immovable property, its delivery requires: (i) a notarial deed for the purpose of transfer of the immovable property; (ii) followed by its entry in the public registers.[397] If the underlying property is a movable property, its delivery occurs by provision of possession of the movable property to the transferee.[398] A transferor provides possession of the movable property by enabling the transferee to exercise such control over the movable property as the transferor was able to exercise over it.[399] This means that the transferor can physically deliver the movable property to the transferee. A bilateral declaration without physical delivery is, however, also sufficient to transfer possession.[400]

In a conventional A–B–C transaction under Dutch law, whereby party A sells a tangible property to party B and party B sells it to party C (as is the case in a *murabaha* transaction), party A can deliver the tangible property to party C directly. This is, however, not possible in the *sukuk al-murabaha* transaction. According to the Islamic finance rules for the *sukuk al-murabaha*, the SPV should become the owner of the tangible property.[401] The right of ownership of the tangible property should be transferred to the SPV first, after which the SPV can transfer its right of ownership to the originator.

A *sukuk al-murabaha* transaction is a finance transaction. The SPV is incorporated only to facilitate the transaction. If the subject matter of the transaction is a movable property, the third-party seller and the SPV will prefer transfer of possession of the movable property to the SPV through a bilateral declaration without physical delivery. The third-party seller can transfer the possession of the movable property to the SPV according to Article 3:115 (a) DCC. This is referred to as a *traditio constituto possessorio* delivery (CP-delivery). *Traditio constituto possessorio* literally means 'transfer with ownership statement,' referring to the statement of the transferor to hold the movable property for the transferee and not for himself anymore. [402] The third-party seller stipulates that it holds the movable property for the SPV henceforth. Consequently, the movable property is delivered to the SPV and the SPV becomes its owner.

Next, the ownership of the movable property is delivered by the SPV to the originator. The SPV can deliver the movable property by provision of its

397 Art. 3:89 (1) DCC.
398 Art. 3:90 (1) DCC.
399 Art. 3:114 DCC.
400 Art. 3:115 DCC.
401 *See* the second Islamic finance rule for the *sukuk al-murabaha*, as mentioned in Section 5.2.1 of this chapter.
402 Pitlo/Reehuis & Heisterkamp 2012, pp. 184-187.

possession (*bezitsverschaffing*) to the originator.[403] This can be realised in one of the following three forms:

1. by way of physical delivery of the movable property to the originator;
2. with a bilateral declaration without physical delivery due to Article 3:115 (a) DCC; or
3. with a bilateral declaration without physical delivery due to Article 3:115 (c) DCC.

In the *sukuk al-murabaha* transaction the originator physically acquires the movable property from the third-party seller. The third-party seller performs the physical delivery in the name of the SPV based on its legal relationship with the SPV.[404] Thus, the SPV is regarded to transfer possession (*bezitsoverdracht*) of the movable property to the originator.[405] It should, however, be noted that in a finance transaction such as the *sukuk al-murabaha* the SPV and the originator would like to have certainty with regard to their legal positions at the moment of the execution of the finance documents and not after physical delivery of the movable property. In addition, a physical delivery of the movable property adds an, although minimal, insolvency risk into the transaction: if the SPV goes bankrupt after payment of the purchase price by the originator to the SPV and before physical delivery of the movable property to the originator, the movable property will fall into the bankruptcy estate of the SPV.[406] The SPV and the originator may, therefore, prefer transfer of possession of the movable property with a bilateral declaration without physical delivery.

> The *murabaha* transaction is accepted from an Islamic law perspective with the argument that the financier (SPV) owns the property for a moment with the associated risks thereof.[407] Remarkably, the insolvency risk of the SPV mentioned above is such risk that could justify this transaction from an Islamic law perspective because of its profit-and-loss sharing characteristic. Nonetheless, as mentioned in chapter 3, such risks are often mitigated because both transfers (between the third-party seller and the SPV and between the SPV and the originator) occur simultaneously in practice and *Shari'ah* scholars have accepted such practice as *Shari'ah*-compliant.[408] Consequently, when the *sukuk al-murabaha* is structured

403 Art. 3:90 (1) DCC.
404 *Cf.* Art. 3:110 DCC. *See also* Asser/Bartels & Van Mierlo 2013 (3-IV), no. 165; Pitlo/Reehuis & Heisterkamp 2012, pp. 181-182 & 242-243; Snijders & Rank-Berenschot 2012, pp. 370-371.
405 *See* Art. 3:114 DCC.
406 *See* Arts. 23 and 35 DBA.
407 *See* Section 3.2.1 of Chapter 3.
408 *Ibid.*

under Dutch law the originator and the SPV will also look for ways to mitigate such risks.

In case of transfer of possession with a bilateral declaration without physical delivery, the SPV can deliver the movable property to the originator through a CP-delivery. The SPV stipulates that it will hold the movable property for the originator henceforth. The originator then becomes the owner of the movable property. The movable property will be physically relocated to the originator at a later date.

Alternatively, in case of transfer of possession with a bilateral declaration without physical delivery, the SPV can also deliver the movable property to the originator pursuant to Article 3:115 (c) DCC. A delivery pursuant to Article 3:115 (c) DCC is called *traditio longa manu*, meaning 'transfer with the long hand'.[409] After the CP-delivery from the third-party seller to the SPV, the SPV becomes the owner of the movable property. The movable property remains physically with the third-party seller, who holds it for the SPV. The SPV then delivers the movable property to the originator through a *traditio longa manu*. The third-party seller holds the movable property for the originator henceforth. The third-party seller should be notified of the transfer of the movable property from the SPV to the originator so that the requirement of Article 3:115 (c) DCC is met and the ownership of the movable property is transferred to the originator, followed by its physical relocation to the originator at a later date.

A delivery *traditio longa manu* is preferred to a CP-delivery for the transfer from the SPV to the originator. In this research I have assumed that the third-party seller is the owner of the movable property. In practice it is, however, possible that a creditor of the third-party seller has a non-possessory right of pledge (*bezitloos pandrecht*) on the movable property. If the originator does not know nor should have known about such non-possessory right of pledge at the moment of the transfer, such right of pledge of the creditor of the third-party seller is extinguished on the basis of Article 3:86 (2) DCC. According to Article 3:90 (2) DCC, a CP-delivery has no effect towards a third party with a prior right on the movable property until the moment when the movable property has come into the hands of the transferee, unless the third party has consented to the transfer. However, Article 3:90 (2) DCC does not apply to a delivery *traditio longa manu*, which means that the originator is protected against third parties with prior rights on the movable property on the basis

409 Pitlo/Reehuis & Heisterkamp 2012, pp. 191-193.

of Article 3:86 (2) DCC, provided that the originator did not know nor should have known about such rights.[410]

> The Dutch Supreme Court acknowledged that the delivery *traditio longa manu* is legally equal to a physical delivery of a property.[411] Therefore, the risks associated with the CP-delivery are not present in case of a delivery *traditio longa manu*. The reason for the different treatment of the CP-delivery and the delivery *traditio longa manu* is that according to the Dutch Supreme Court a delivery *traditio longa manu* results in a material delivery after the transferor or transferee gives notice to the third-party holder, while a CP-delivery does not result in a material delivery. The Dutch Supreme Court, furthermore, referred to the principle of publicity: while in the case of a transfer through a CP-delivery the transfer occurs exclusively between the parties involved without any outward expressions, a transfer through a delivery *traditio longa manu* is not unknowable and not uncontrollable for another party because a third-party holder is involved who will onwards hold the property for the transferee instead of the transferor and who can inform another party in this regard whenever asked.[412]

5.2.2.2 Security Rights to Secure Instalments under Dutch Property Law

The originator pays the purchase price in instalments to the SPV. The SPV will, therefore, require security to secure the instalments. Under Dutch law the first form of security that comes to mind is the reservation of ownership according to Article 3:92 (1) DCC.[413] If the tangible property is transferred with the reservation of ownership, the SPV remains the owner of the tangible property until the originator has paid the full purchase price.[414] The reservation of ownership is, however, in conflict with Islamic law for two reasons.[415] First, the right of ownership of a tangible property transfers immediately to the transferee (originator), with the conclusion of the contract of sale under Islamic property law. Second, it is not possible to make the transfer of ownership conditional, for example, upon payment of the full purchase price by the originator, under Islamic property law.

410 *See* Dutch Supreme Court 1 May 1987, *NJ* 1988, 852, with case note by Kleijn; Dutch Supreme Court 18 September 1987, *NJ* 1988, 983, with case note by Kleijn.
411 Dutch Supreme Court 1 May 1987, *NJ* 1988, 852, with case note by Kleijn; Dutch Supreme Court 18 September 1987, *NJ* 1988, 983, with case note by Kleijn.
412 See Dutch Supreme Court 18 September 1987, NJ 1988, 983, with case note by Kleijn.
413 For more on the Dutch reservation of ownership, *see* Vriesendorp 1985a.
414 This is the presumption by law, *see* Art. 3:92 (1) DCC.
415 *See* the third Islamic finance rule for the *sukuk al-murabaha*, as mentioned in Section 5.2.1 of this chapter. For more on the reasons for the impermissibility of the reservation of ownership under Islamic law, *see* Section 2.3 of Chapter 2.

The originator can, nonetheless, create a security right to secure the outstanding instalments in favour of the SPV. According to Islamic finance law, the originator should have incurred a debt for which the security is granted and it should own and possess the tangible property over which it creates a security right.[416] These requirements return under Dutch property law: a security right should secure a debt[417] and a security right can only be granted by the party who has the right to dispose of the property.[418] Under Islamic finance law, the security right can be a 'fiduciary pledge'.[419] Such 'fiduciary pledge' under Islamic finance law resembles what is known under Dutch property law as a transfer subject to the reservation of a security right (*overdracht onder voorbehoud van een zekerheidsrecht*). According to Article 3:81 (1) DCC, a party entitled to an independent (*zelfstandig*) and transferable (*overdraagbaar*) right can transfer its right subject to the reservation of a limited right (*beperkte recht*), provided that such party respects the requirements for both (i) the transfer of the property and (ii) the creation of the limited right.

In the previous subsection, I already discussed the rules for a valid transfer.[420] The creation of a security right also requires: (i) establishment (*vestiging*); (ii) pursuant to a valid title; (iii) by the party who has the right to dispose of the property.[421] The valid title for the creation of the security right can be stipulated in the contract of sale between the SPV and the originator, which should address that the tangible property is transferred subject to the reservation of a security right. The contract of sale should clearly stipulate the intention of the originator and the SPV to transfer the tangible property and also to create a security right over the tangible property.[422] The party who has the right to dispose of the tangible property is the SPV.[423] The asset is transferred by the SPV to the originator simultaneously with the creation of a security right that remains with the SPV. The originator acquires the right of ownership of the tangible property encumbered with a security right from the outset. If the property is an immovable property, a right of mortgage can be created through a notarial deed and its registration in the public registers.[424] For both the transfer of the immovable property from the SPV to the originator

416 *See* the fourth and fifth Islamic finance rules for the *sukuk al-murabaha*, as mentioned in Section 5.2.1 of this chapter.
417 Art. 3:227 DCC.
418 Art. 3:98 in conjunction with 3:84 (1) DCC.
419 *See* the fifth Islamic finance rule for the *sukuk al-murabaha*, as mentioned in Section 5.2.1 of this chapter.
420 *See* Section 5.2.2.1 of this chapter.
421 Art. 3:98 in connection with Art. 3:84 (1) DCC.
422 Dutch Supreme Court 4 December 1998, *NJ* 1999, 549, with case note by Kleijn/*AA* 1999, 288, with case note by Van Mierlo, case note Van Mierlo, under 4; Vriesendorp 1985b, p. 534.
423 Parliamentary History, Book 3 DCC 1981, p. 407.
424 Art. 3:260 (1) DCC.

> and the creation of the right of mortgage for the SPV, parties can suffice with a single notarial deed and its registration in the public registers, provided that the notarial deed separately and clearly stipulates that it is intended for both the transfer of the property and the creation of a right of mortgage.[425] If the property in the *sukuk* transaction is a movable property which is transferred through a delivery *traditio longa manu*, a right of pledge can be created without bringing the movable property physically under the control of the pledgee, *i.e.* the SPV, through an authentic deed (*authentieke akte*) or a registered private instrument (*geregistreerde onderhandse akte*).[426]

The most significant advantage of a transfer of a tangible property subject to the reservation of a security right relates to the ranking of the security right of the SPV in relation to other security rights. In *Potharst/Serrée*, the Dutch Supreme Court confirmed that upon the transfer of the right of ownership subject to the reservation of a right of pledge the transferee acquires a right of ownership that is encumbered with a right of pledge from the outset.[427] The right of pledge remains with the transferor, so the transferee is not able to establish a right of pledge that can be regarded as a previously created right of pledge.[428] The Dutch Supreme Court ruled that rights of pledges granted by the transferee to other parties are not effective against a transferor/pledgee who has transferred the movable property subject to a reservation of a right of pledge, not even when the transferee has granted the right of pledge to other parties in advance, that is, before the transfer subject to the reservation of the right of pledge occurred.[429] In the *sukuk al-murabaha* transaction it is, for example, conceivable that the originator has provided other parties security rights on all its properties and all its future properties (*i.e.* properties it is anticipating to acquire in the future). As a result of *Potharst/Serrée*, the

425 *See* Art. 24 (4) Land Registry Act (*Kadasterwet*). If the notarial deed does not separately and clearly stipulate that it is intended for both the transfer of the immovable property and the creation of a right of mortgage, the right of mortgage is not created. For the considerations of the Dutch legislature with regard to the acceptance of a single notarial deed for both the transfer of the immovable property and the creation of a right of mortgage, *see* Parliamentary History, Act Implementing Books 3, 5 and 6 DCC 1990, pp. 1195-1196.

426 Art. 3:237 (1) DCC.

427 Dutch Supreme Court 4 December 1998, *NJ* 1999, 549, with case note by Kleijn/*AA* 1999, 288, with case note by Van Mierlo, para. 3.6.4.

428 Under Dutch property law, it is possible to create a right of pledge in advance, according to Art. 3:98 in conjunction with 3:97 (1) DCC. The right of pledge is not created yet. The formalities required for its registration are only fulfilled in advance based on Art. 3:98 in conjunction with 3:97 (1) DCC. Once the pledgor becomes the owner of the movable property, the right of pledge is created according to Art. 3:84 (1) DCC. It is not possible to create a right of mortgage in advance, *see* Art. 3:97 (1) DCC.

429 Dutch Supreme Court 4 December 1998, *NJ* 1999, 549, with case note by Kleijn/*AA* 1999, 288, with case note by Van Mierlo, para. 3.6.4.

security right of the SPV has a higher priority in ranking than those security rights.

> The counterparties of the originator to whom the originator might have granted rights of pledges do no rank higher in priority with an appeal on third-party protection according to article 3:238 (2) DCC either.[430] Such protection is only given to those who have the movable property under their control (*macht*) due to their right of pledge and who have acted in good faith (*te goeder trouw*) at the moment when the movable property was brought under their control.[431] In the *sukuk al-murabaha* transaction, however, the originator often needs the movable property for its business which means that the movable property will remain under its control.

5.2.3 *Sukuk al-Murabaha* under Dutch Contract Law: *Murabaha* as Instalment Sale within the Meaning of Book 7A DCC

The contract of sale between the SPV and the originator qualifies as a purchase and sale of property on instalments (*koop en verkoop op afbetaling*), in short an instalment sale, according to Article 7A:1576 (1) DCC. That article defines an instalment sale as a purchase and sale where parties agree that the purchase price is paid in at least two instalments that commence after the property is physically delivered to the purchaser. The instalment sale is a genus consisting of two species:[432] (i) instalment sale with an unconditional transfer of the right of ownership; and (ii) instalment sale with the transfer of the right of ownership under the suspensive condition of payment of the purchase price, also referred to as hire purchase (*huurkoop*).[433] In the *sukuk al-murabaha*, the transfer of the tangible property from the SPV to the originator occurs unconditionally. The transfer is subject to the reservation of a security right, but this does not alter the fact that the transfer of the right of ownership is unconditional and that the originator becomes the owner of the tangible property. It only results in the tangible property being encumbered with a security right from the outset.

Book 7A DCC provides mandatory rules (*dwingend recht*) for instalment sales.[434] The mandatory provisions of book 7A DCC do not apply to the purchase of immovable property.[435] The provisions discussed below are only

430 *See* Dutch Supreme Court 4 December 1998, *NJ* 1999, 549, with case note by Kleijn/*AA* 1999, 288, with case note by Van Mierlo, case note Van Mierlo, under 7. *Cf.* Dutch Supreme Court 4 December 1998, *NJ* 1999, 549, with case note by Kleijn/*AA* 1999, 288, with case note by Van Mierlo, para. 3.6.4.
431 *See* Art. 3:238 (1) and (2) DCC.
432 Explanation Draft Meijers 1972, p. 863.
433 *See* Art. 7A:1576h *ff.* DCC.
434 Art. 7A:1576a DCC.
435 Art. 7A:1576 (4) (a) DCC.

relevant if the underlying property in the *sukuk al-murabaha* is a movable property.

> The IHPIPA which provides mandatory rules for hire purchase of immovable property does not apply to the *murabaha* in the *sukuk al-murabaha* either. Article 1 (1) IHPIPA defines a hire purchase agreement as an instalment sale where parties agree that the ownership of the sold tangible property is not transferred by sole physical delivery, but only upon fulfilment of the suspensive condition of payment in full of whatever is due by the buyer under the sale contract.[436] A hire purchase agreement is, thus, an instalment sale with the reservation of ownership. There is no reservation of ownership in the *murabaha* in the *sukuk al-murabaha*. The right of ownership of the tangible property is transferred unconditionally. According to article 1 (2) IHPIPA all agreements with the same essence as hire purchase, either made in the form of a rental agreement or in any other form or name, are considered a hire purchase agreement.[437] The *murabaha* does not qualify as an agreement with the same essence of hire purchase either because an essential element of the statutory definition of hire purchase is lacking in the *murabaha*, *i.e.* the reservation of ownership.[438] The transfer of the movable property subject to the reservation of a security right in the *murabaha* transaction does not alter this fact because a security right does not provide the security right holder (SPV) the right of ownership of the movable property in case of default on an instalment payment by its debtor (originator) under Dutch law.[439]

Book 7A DCC used to provide mandatory rules for early payments. From an Islamic finance law perspective, the SPV and the originator cannot stipulate that a rebate will be given to the originator in case of early payment of the purchase price.[440] If the SPV wishes to provide a rebate out of leniency alone, it is permitted to do so.[441] However, the SPV should not have the obligation to provide a rebate to the originator. The former Article 7A:1576e DCC imposed a mandatory annual discount in case of early payment of the entire amount due: the purchaser was entitled to an annual discount of 5% on each instalment paid early.[442] Such discount on early paid instalments could have been

436 *Cf.* Art. 7A:1576h (1) DCC.
437 *Cf.* Art. 7A:1576h (2) DCC.
438 For more on the essential elements of the statutory definition of hire purchase in relation to agreements with the same essence as hire purchase, *see* Section 5.3.3.2 of this chapter.
439 Art. 3:235 DCC.
440 *See* the sixth Islamic finance rule for the *sukuk al-murabaha*, as mentioned in Section 5.2.1 of this chapter.
441 Art. 5/9 AAOIFI SS 8.
442 *See* former Art. 7A:1576e (2) DCC. The purchaser had the right to pay one or more following instalments early under former Art. 7A:1576e (1) DCC. It was possible to deviate from these mandatory rules only if it was favourable to the purchaser, *see* former Art. 7A:1576e (3) DCC.

conflicting with Islamic law.[443] On 25 May 2011, Article 7A:1576e DCC was, however, abolished with the trading into force of an Amendment Act of Book 7 DCC, *ff.* amending, among other acts, book 7 and 7A DCC as a result of the implementation of the Consumer Credit Directive (Directive 2008/48/EC).[444] With the implementation of the Consumer Credit Directive, Title 2a on Consument Credit Agreements (*Consumentenkredietovereenkomsten*) was introduced in book 7 DCC, which contains a specific provision on early repayment of consumer credit in Article 7:68 DCC.[445] The addressed provision does not affect *sukuk* transactions.

> The Dutch legislature is also working on a legislative proposal for the further implementation of the Consumer Credit Directive through the implementation of a new Title 7.2b and 7.2c on Consumer Credit Agreements (*Consumentenkredietovereenkomsten*), Purchase Credit (*Goederenkrediet*) and Loans (*Geldlening*) in book 7 DCC.[446] Articles III and V of the Draft Legislative Proposal on Consumer Credit Agreements, Purchase Credit and Loans propose to abolish the mandatory provisions in book 7A for instalment sale and hire purchase and to repeal the IHPIPA.

Article 7A:1576b DCC contains mandatory rules for penalty clauses. Under Islamic finance law, the SPV and the originator can stipulate a penalty clause in the *murabaha* contract, provided that the SPV pays that amount to a charity.[447] Article 7A:1576b DCC does not prevent the originator and the SPV from contractually agreeing that if a penalty is charged, the amount incurred by the originator towards the SPV should be paid to a charity. Article 7A:1576b (1) DCC requires that penalty clauses, *i.e.* stipulations that oblige the transferee to pay an amount of money in case of default, are in writing.[448] The originator and the SPV should, furthermore, be aware that according to Article 7A:1576b (2) DCC, a court can reduce or abolish the penalty if the court rules that the penalty is excessive. Article 7A:1576d DCC states that the penalty can only be incurred if the originator remains in default after the SPV has sent notice of default (*ingebrekestelling*). Consequently, the mandatory rules of book 7A DCC do not raise any tension with Islamic finance law.

443 In addition, it might also lead to practical concerns in finance transactions, *see* Van Rossum 2009, pp. 362-363.
444 *See* Art. I (C) Amendment Act of Book 7 DCC, *ff.* regarding implementation of Directive 2008/48/EC.
445 For more on Title 2a on Consument Credit Agreements in book 7 DCC, *see* Biemans 2013.
446 Draft Legislative Proposal on Consumer Credit Agreements, Purchase Credit and Loans.
447 *See* the seventh Islamic finance rule for the *sukuk al-murabaha*, as mentioned in Section 5.2.1 of this chapter.
448 This is in line with the principle of *gharar* and the basic principle of Islamic contract law that parties are encouraged to write down their obligations, *see* Sections 2.2.2 and 2.3.2 of Chapter 2.

> Under Dutch law the authority of a court to reduce or abolish the penalty in case it is excessive is meant to avoid burdening the financial needy excessively. This resembles the rationale for the restrictions on penalty clauses under Islamic law. As a starting point, stipulating a penalty clause in the *murabaha* is forbidden under Islamic law. According to Islamic scholars, the payment of a penalty in case of default on an instalment resembles interest and is prohibited as a result of the ban on *riba*. Furthermore, a penalty burdens the financial needy excessively and is, therefore, not allowed under Islamic law. However, penalty clauses were permitted by way of exception in *murabaha* transactions under Islamic finance law in order to give the originator an incentive to pay on time, provided that the amount is paid to a charity.

Concluding, the *murabaha* in the *sukuk al-murabaha* can be structured under Dutch law. The third-party seller transfers the *halal* tangible property to the SPV, followed by its transfer by the SPV to the originator subject to the reservation of a security right. If the underlying property is a movable property, the third-party seller delivers it through a CP-delivery to the SPV and the SPV delivers it through a delivery *traditio longa manu* to the originator. The movable property is physically relocated by the third-party seller to the originator at a later date. The contract of sale between the SPV and the originator qualifies as an instalment sale. The Islamic finance rules for the *murabaha* are not in conflict with the mandatory rules in book 7A DCC.

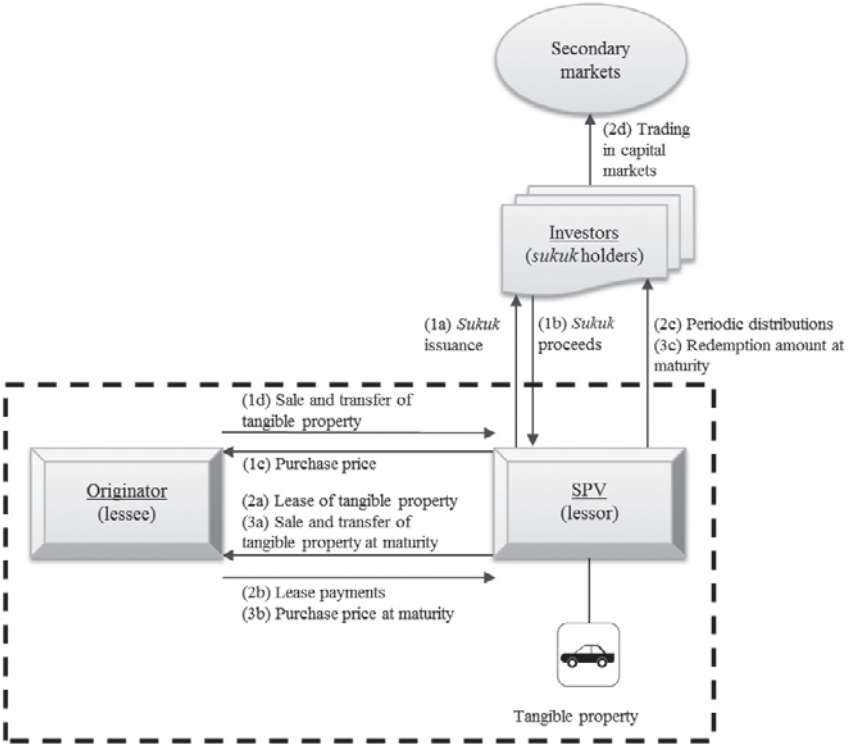
5.3 The *Ijarah* in the *Sukuk al-Ijarah* under Dutch Property and Contract Law

5.3.1 Islamic Finance Rules for Sale and Leaseback in *Sukuk al-Ijarah*

The *sukuk al-ijarah* structure is based on a sale and leaseback between an originator and an SPV. The originator incorporates the SPV. The originator sells and transfers a *halal* tangible property to the SPV. The SPV issues *sukuk* in financial markets to fund the purchase of the tangible property. The SPV uses the *sukuk* proceeds, received from the *sukuk* holders, to pay the purchase price of the tangible property to the originator. The SPV becomes the owner of the tangible property and leases it back to the originator. The originator makes lease payments to the SPV for the use of the tangible property. The SPV, in turn, pays the lease payments through to the *sukuk* holders as periodic distributions over the *sukuk*. This continues until the maturity date of the *sukuk*. At the maturity date of the *sukuk*, the SPV sells and transfers the *halal* tangible property back to the originator. The SPV pays the purchase price, which it receives from the originator, through to the *sukuk* holders. The *sukuk* will be redeemed. The focus of this section is on the sale and leaseback, as marked in

Figure 3. I will assess the sale and leaseback in the *sukuk al-ijarah* under Dutch property and contract law. The legal form of the SPV and the legal relationship between the SPV and the *sukuk* holders are discussed in the next chapter.

Figure 3 Underlying Islamic finance contract in *sukuk al-ijarah* under Dutch law



In Chapter 4 I formulated five Islamic finance rules for the *sukuk al-ijarah*. In this chapter I take these five rules as my theoretical framework and assess them under Dutch law:

1. the originator should be the owner and the possessor of the tangible property before the conclusion of the contract of sale with the SPV;
2. the SPV should become the owner and the possessor of the tangible property after the conclusion of the contract of sale with the originator;
3. the *ijarah* contract between the SPV and the originator should stipulate that the liabilities and the risks attached to the ownership of the tangible property are borne by the SPV;

4. if a promise of *wa'd* is provided by the originator to offer to purchase the tangible property at the maturity date of the *sukuk*, it may not be a bilateral promise. It should be binding only on the originator; and
5. at the maturity date of the *sukuk*, a new offer and acceptance are required to conclude a new contract of sale between the originator and the SPV. The binding promise may not be an offer.

The five Islamic finance rules for the *sukuk al-ijarah* have to be met in order to acquire the approval of a *Shari'ah* supervisory board. As a result, the securities can be offered as *sukuk* in financial markets. As a starting point, I will take the first rule as a given: I assume that the originator is the owner and the possessor of the *halal* tangible property. The second Islamic finance rule relates to the transfer of the right of ownership of the tangible property to the SPV and is assessed under Dutch property law (Section 5.3.2). The originator should transfer the ownership of the tangible property to the SPV and it should also deliver it to the SPV so that the SPV becomes the owner and the possessor of the tangible property. The SPV becomes the owner of the tangible property with the conclusion of the contract under Islamic property law. It should also become the possessor of the tangible property in order to be able to transfer it to the originator at the maturity of the *sukuk*, which means that the tangible property should also be delivered to it. Dutch law requires the delivery of a tangible property for a valid transfer of its rights of ownership. Thus, the second Islamic finance rule requires a valid transfer of the right of ownership of the tangible property from the originator to the SPV under Dutch law.

The third, fourth and fifth Islamic finance rules are assessed under Dutch contract law (Section 5.3.3). The fourth and fifth rules determine the legal form of the promise of *wa'd* (Section 5.3.3.1). The conclusion of a contract of sale has the immediate effect of the transfer of the right of ownership of a tangible property under Islamic property law and, therefore, it is not possible to conclude a contract of sale pursuant to which the ownership of a tangible property is transferred at a future date. The promise of *wa'd* provided by the originator to the SPV pursuant to which the originator promises to offer to purchase the tangible property at the maturity of the *sukuk* should only be binding on the originator. Otherwise, a contract of sale is effectively concluded. For the same reason, a new offer and acceptance are required at the maturity of the *sukuk* to conclude a new contract of sale between the originator and the SPV. The promise of *wa'd* cannot be an offer because otherwise its sole acceptance will lead to the conclusion of a contract of sale. Finally, the third Islamic finance rule for the *sukuk al-ijarah* determines the contents of the *ijarah* contract (Section 5.3.3.2). The SPV as the owner of the tangible property should bear the liabilities and the risks attached to its ownership.

5.3.2 Sale and Leaseback in *Sukuk al-Ijarah* and the *Fiducia* Prohibition under Dutch Property Law

A valid transfer of the *halal* tangible property from the originator to the SPV in the *sukuk al-ijarah* should meet the requirements of Article 3:84 (1) DCC: (i) delivery; (ii) pursuant to a valid title; (iii) by the party that has the right to dispose of the property. The originator as the owner of the tangible property has the right to dispose of the tangible property. If the property in a *sukuk al-ijarah* is an immovable property, its delivery requires a notarial deed and its registration in the public registers.[449] If the property is a movable property, the most convenient way to deliver it is through a CP-delivery.[450] In the case of sale and leaseback transactions, movable properties are often delivered through CP-deliveries so that the property can remain with the transferor/lessee (originator).

The title for the transfer of the *halal* tangible property from the originator to the SPV deserves closer consideration under Dutch property law. The legal validity of financial transactions are often questioned in light of Article 3:84 (3) DCC.[451] In the Netherlands there has been much discord concerning the legal validity of the title for (conventional) sale and leaseback transactions in light of the *fiducia* prohibition of Article 3:84 (3) DCC.[452] I next assess whether the sale and leaseback in the *sukuk al-ijarah* is a transfer for security purposes (*fiducia cum creditore*), which is invalidated by Article 3:84 (3) DCC.[453]

> Article 3:84 (3) DCC states that a legal act (i) that is 'intended to transfer property for purposes of security' or (ii) which 'does not have the purpose of bringing the property into the patrimony of the transferee' does not constitute a valid title for the transfer of that property. The first type of legal act that does not constitute a valid title due to the *fiducia* prohibition is referred to as the *fiducia cum creditore*.

449 Art. 3:89 (1) DCC.

450 Art. 3:90 in conjunction with 3:115 (a) DCC.

451 The legal validity of the following financial transactions are questioned in light of Art. 3:84 (3) DCC: leveraged leasing, repurchase agreements (repo's), sale and leaseback transactions, securitisations, covered bond programs and *sukuk* transactions. *See* Rank 1998; Wibier 2008, pp. 146-152; Salomons & Van 't Westeinde 2008a, pp. 453-460; Wibier (*reactie*) 2008, pp. 715-717; Salomons & van 't Westeinde (*naschrift*) 2008, pp. 717-718; Rongen 2012, pp. 795-978; Salah 2010d, pp. 271-272.

452 Salomons 1994, pp. 1261-1266; Heyman 1994, pp. 1-14; Kleijn 1994, pp. 15-17; Kortmann 1994, pp. 18-23; Kortmann & Van Hees 1995, pp. 991-996; Vegter 1995a, pp. 534-536; Vegter 1995b, pp. 555-557; Salomons 1995, pp. 820-822; Lokin *(Fiduciaire verhoudingen: Libellus Amicorum Prof. Mr. S.C.J.J. Kortmann)* 2007, pp. 137-155; Salah 2013a, pp. 138-146.

453 Art. 3:84 (3) DCC is also relevant with regard to the legal relationship of the SPV and the *sukuk* holders. One may argue that the legal relationship between the SPV and the *sukuk* holders is in conflict with the *fiducia* prohibition, more in particular with the *fiducia cum amico*. I will discuss the legal validity of the relationship between the SPV and the *sukuk* holders in light of Art. 3:84 (3) DCC in Chapter 6.

> It refers to a fiduciary security transfer. The second type of legal act is referred to as the *fiducia cum amico*. That is a transfer of property for purposes of administration that lacks the intention of bringing the property into the patrimony of the transferee. In general, (conventional) sale and leaseback transactions have a security feature. The transferor/lessee acquires 'funding' in the form of the purchase price paid for the property sold. The periodic lease payments paid by the transferor/lessee to the transferee/lessor resemble 'interest' paid for the 'funding'.[454] The transferee/lessor holds the right of ownership of the property as 'collateral', while the transferor/lessee has the right to use the property. Conventional leasing companies, for example, often use sale and leaseback transactions to acquire some form of security for the payment of the lease price.[455]

In the landmark case *Keereweer q.q./Sogelease*, also known as *Sogelease*, the Dutch Supreme Court ruled that the sale and leaseback addressed did not intend to transfer property for purposes of security within the meaning of Article 3:84 (3) DCC.[456] According to the Dutch Supreme Court, the criterion for the application of Article 3:84 (3) DCC in relation to fiduciary security transfers is whether the legal act has the purpose of providing the transferee/lessor a security right on the property in such manner that it protects his interests as creditor in relation to other creditors of the transferor/lessee.[457] The essence of such protection as creditor is by nature the right to have recourse to the transferred property with priority over other creditors of the transferor/lessee, *e.g.* the contract restricts the right of the transferee/lessor in such manner that in case of default of the transferor/lessee, the transferee/lessor will have only the restricted right to sell the property, have recourse to the proceeds and pay any excess back to the transferor/lessee.[458] If the legal act, on the other hand, intends an 'actual transfer', *i.e.* a transfer of property to the transferee/lessor without any proprietary limitation, Article 3:84 (3) DCC does not preclude it.[459] Thus, Article 3:84 (3) DCC only invalidates the transfer of property, which in essence gives the transferee only a security right. In *B.T.L.*

454 The comparison of the sale and leaseback with an interest-based loan might raise the question whether the sale and leaseback in the *sukuk al-ijarah* is not in conflict with Islamic finance law. For the *Shari'ah* compliance of the sale and leaseback in the *sukuk al-ijarah*, *see* Chapter 4.

455 Pitlo/Reehuis & Heisterkamp 2012, pp. 88-90.

456 Dutch Supreme Court 19 May 1995, *NJ* 1996, 119, with case note by Kleijn/*AA* 1995, 11, with case note by Vriesendorp. If the transfer had been a fiduciary security transfer within the meaning of Art. 3:84 (3) DCC, the fiduciary ownership of the fiduciary owner had to be converted into a right of pledge, *see* Art. 86 (1) Transitional Act of the new Dutch Civil Code (*Overgangswet nieuw Burgerlijk Wetboek*).

457 Dutch Supreme Court 19 May 1995, *NJ* 1996, 119, with case note by Kleijn/*AA* 1995, 11, with case note by Vriesendorp, para. 3.4.3.

458 *Ibid.*

459 *Ibid.*

Lease/Erven Van Summeren, also known as *B.T.L. Lease*, the Dutch Supreme Court ruled that the Haviltex criterion[460] should be used to explain the title for the transfer of property when assessing whether there has been an 'actual transfer' of property.[461]

> In its ruling in *Sogelease*, the Dutch Supreme Court stressed the background of the fiduciary security transfer as developed in case law before the introduction of the current Dutch Civil Code: the fiduciary security transfer provided an alternative for the possessory right of pledge in the form of a non-possessory security. Before the introduction of the current Dutch Civil Code in 1992, a non-possessory right of pledge (*bezitloos pandrecht*) on movable property did not exist.[462] If a financier required security in the form of a right of pledge on movable property, the borrower had to bring the movable property under the possession of the financier. Obviously, this was inconvenient if the borrower needed the movable property to conduct its business. It was, however, possible to transfer the ownership of property through a CP-delivery. When security over movable property was required, while the borrower required the property for its business, the property was transferred for security purposes. This practice was accepted by the Dutch Supreme Court in two cases in 1929.[463] In the subsequent decades, the statutory provisions for rights of pledges and rights of mortgages were applied by analogy to fiduciary security transfers.[464] According to the Dutch Supreme Court in *Sogelease*, it is this form of fiduciary security transfer that is prohibited by article 3:84 (3) DCC

460 In *Ermes et al./Haviltex* the Dutch Supreme Court provided the criterion for the explanation of agreements, the so-called Haviltex criterion: 'in essence it comes down to the meaning that parties can reasonably attach to each other's statements and behaviour, in the circumstances concerned, and to what they, in that respect, could reasonably expect from each other'. *See* Dutch Supreme Court 13 March 1981, *NJ* 1981, 635, with case note by Brunner.

461 Dutch Supreme Court 18 November 2005, *NJ* 2006, 151. This was in line with earlier case law of the Dutch Supreme Court. In *ING/Muller* the Dutch Supreme Court ruled that the Haviltex criterion should be used to explain the title (*i.e.* the legal basis that obliged to create the right of pledge) that underlies the deed of creation of a right of pledge, *see* Dutch Supreme Court 20 September 2002, *NJ* 2002, 610, with case note by Du Perron.

462 Salah 2013a, pp. 138-139.

463 *See* Dutch Supreme Court 25 January 1929, *NJ* 1929, 616, with case note by Scholten; Dutch Supreme Court 21 June 1929, *NJ* 1929, 1096.

464 *See* Dutch Supreme Court 13 January 1938, *NJ* 1938, 566, with case note by Scholten; Dutch Supreme Court 3 January 1941, *NJ* 1941, 470, with case note by Scholten; Dutch Supreme Court 30 January 1953, *NJ* 1953, 578, with case note by Houwing; Dutch Supreme Court 6 March 1970, *NJ* 1970, 433, with case note by Houwing; Dutch Supreme Court 7 March 1975, *NJ* 1976, 91, with case note by Kleijn; Dutch Supreme Court 18 September 1987, *NJ* 1988, 983, with case note by Kleijn; Dutch Supreme Court 18 December 1987, *NJ* 1988, 340, with case note by Van der Grinten; Dutch Supreme Court 18 September 1992, *NJ* 1993, 455, with case note by Snijders; Dutch Supreme Court 5 November 1993, *NJ* 1994, 258, with case note by Kleijn.

because an alternative was introduced with the non-possessory right of pledge of article 3:237 DCC in the current Dutch Civil Code.[465]

Article 3:84 (3) DCC does not invalidate the title for the transfer of the tangible property from the originator to the SPV in the sale and leaseback in the *sukuk al-ijarah*. The originator and the SPV intend an 'actual transfer' of the tangible property from the originator to the SPV. The purpose of the *sukuk al-ijarah* transaction is to attract *Shari'ah*-compliant funding and, therefore, the originator and the SPV wish to meet the Islamic finance rules for such transaction. According to the Islamic finance rules for a *sukuk al-ijarah*, there must be a transfer of the right of ownership of the tangible property from the originator to the SPV. From an Islamic property law perspective, the SPV should have the complete and free right of disposal of the tangible property.[466] It is, thus, not possible to proprietarily limit the right of ownership of the SPV to a right of recourse to the tangible property. Under Islamic property law, it is not even possible to contractually condition a right of ownership on a future event, such as an event of default with regard to the lease payments.[467] The originator and the SPV 'reasonably expect from each other'[468] that the *sukuk* transaction is a *Shari'ah*-compliant transaction where the Islamic finance rules are respected. They will, thus, intend an 'actual transfer' of the tangible property under Dutch law.

Economically, the originator acquires funding and it gives the SPV 'collateral' through the transfer of the right of ownership of the tangible property. Legally, the right of ownership of the SPV is not limited to a security right under Dutch law.[469] The legal form of the transaction is such that an 'actual transfer' occurs and that parties agree to 'stronger collateral' through the use of the right of ownership, instead of a security right. The legal form of the 'collateral' in the *sukuk al-ijarah* (the right of ownership) leads to a practical consideration in these transactions. The originator in the *sukuk al-ijarah* should ensure that it does not sell the tangible property below its value. According to

465 *See* Dutch Supreme Court 19 May 1995, *NJ* 1996, 119, with case note by Kleijn/*AA* 1995, 11, with case note by Vriesendorp, paras. 3.4.2-3.4.3.

466 *See* Section 2.3.1 of Chapter 2.

467 *See* Rule VII of Islamic contract law in Section 2.3.2 of Chapter 2.

468 Dutch Supreme Court 13 March 1981, *NJ* 1981, 635, with case note by Brunner.

469 The distinction between security in the sale and leaseback and a security right (such as a right of pledge respectively right of mortgage) is also addressed in the case notes of *Sogelease* by Kleijn and by Vriesendorp. Kleijn discusses the relation between the different forms of security under Dutch law, *see* Dutch Supreme Court 19 May 1995, *NJ* 1996, 119, with case note by Kleijn/*AA* 1995, 11, with case note by Vriesendorp, case note Kleijn, under 3. Vriesendorp addresses the difference between security through an 'actual transfer' and security through a right of pledge, see Dutch Supreme Court 19 May 1995, *NJ* 1996, 119, with case note by Kleijn/*AA* 1995, 11, with case note by Vriesendorp, case note Vriesendorp, pp. 878-879.

the legal analysis above, the SPV will be the owner of the tangible property under Dutch law. If the tangible property is sold below its value, the originator will be at loss in case of default. As the owner of the underlying *halal* tangible property, the SPV is free to dispose of the tangible property to another party from a property law perspective. If the SPV sells and transfers the tangible property to another party, it is entitled to the entire sale proceeds. Such proceeds may include any excess over the periodic lease payments and the principal. The proceeds may be paid through to the *sukuk* holders if this is stipulated in the terms and conditions of the *sukuk*. The originator will lose property the value of which is higher than the funding it acquired. In order to avoid this scenario, the originator should valuate the tangible property and sell it for the valued price.

> If the recourse of the *sukuk* holders is limited to the underlying *halal* tangible property only, this may also have a downside for them: if the proceeds realised with the sale of the tangible property are less than the principal amount of the *sukuk*, the *sukuk* holders have to bear the losses of such sale. The originator will often ensure that the value of the underlying *halal* tangible property is not of less value than the funding it acquires through the *sukuk* proceeds to keep the *sukuk* attractive for investors so that they are willing to subscribe to the *sukuk*. The originator also provides the SPV a promise of *wa'd*.[470] Nonetheless, the downside of the transaction for the *sukuk* holders stresses the importance of a correct valuation of the tangible property.

5.3.3 *Sukuk al-Ijarah* under Dutch Contract Law

5.3.3.1 The Promise of Wa'd *under Dutch Contract Law*

In the *sukuk al-ijarah* structure the originator provides the SPV a binding promise called *wa'd*, pursuant to which it will offer to purchase the tangible property at the maturity date of the *sukuk* from the SPV for a price equal to the price that the SPV paid for its purchase at the commencement of the structure. The originator provides certainty with regard to the repayment of the principal amount of the *sukuk* so that the *sukuk* are attractive for potential investors in financial markets. The originator ensures that the SPV is paid back the amount it used to purchase the underlying *halal* tangible property from the originator so that the SPV can use that amount to pay back the principal amount of the subscribers to the *sukuk*. As a result, the principal amount of the *sukuk* holders is fixed: the SPV and, consequently, the *sukuk* holders do not take the risk of depreciation of the tangible property.

470 *See* Section 5.3.3.1 of this chapter.

In Chapter 2 I discussed the rationale for the use of promises of *wa'd* under Islamic contract law.[471] Under Islamic contract law it is not possible to enter into future sale contracts, *i.e.* contracts pursuant to which a tangible property will be transferred to the transferee at a future date. The legal effect of a valid contract of sale is the immediate transfer of the right of ownership of a tangible property under Islamic private law.[472] Therefore, in the *sukuk al-ijarah* the originator and the SPV may not enter into a future sale contract either.[473] The originator provides a promise of *wa'd*, often structured through a purchase undertaking, pursuant to which the originator is obliged to offer to purchase the tangible property at the maturity date of the *sukuk*.[474] The binding promise should be binding only on one party: if both the originator and the SPV provide a binding promise pursuant to which they are obliged to sell and purchase the tangible property at a future date respectively, they effectively enter into a future sale contract.[475] Furthermore, the binding promise of *wa'd* should not constitute an offer. Otherwise, its sole acceptance is sufficient to conclude a contract of sale at the maturity date of the *sukuk*.[476]

Under Dutch law, the promise of *wa'd* in the *sukuk al-ijarah* should be structured as a unilateral obligation to offer to purchase the tangible property (*aanbiedingsplicht*).[477] The originator will have the unilateral obligation to offer to purchase the tangible property at a predetermined price (equal to the principal amount of the *sukuk* holders) at the maturity date of the *sukuk*. In essence, this is a binding unilateral obligation of the originator to make an offer to the SPV. At the maturity date of the *sukuk*, the SPV should wait until the originator makes the offer. Once the originator makes the offer, the SPV is free to accept or reject it. The binding unilateral obligation of the originator to offer to purchase the tangible property from the SPV will be a contract between the originator and the SPV under Dutch law. Entering into such contract will, however, not be in conflict with Islamic law. The contract is not a sale contract, but only a contract in which the *wa'd* is documented in the form of a unilateral obligation to offer to purchase the tangible property.

The promise of *wa'd* should be drafted carefully under Dutch law. It is a unilateral contract (*eenzijdige overeenkomst*) with the obligation of the originator

471 *See* Section 2.3.2 of Chapter 2.
472 App. B AAOIFI SS 9.
473 Art. 8/7 AAOIFI SS 9.
474 The use of purchase undertakings has an English law background. Promises of *wa'd* are often structured as undertakings under English law, due to the requirement of consideration for contracts under English law. The use of purchase undertakings is permissible in the *sukuk al-ijarah*. This was confirmed by the AAOIFI in the AAOIFI Resolution of 2008, *see* Section 4.3.3 of Chapter 4.
475 *Cf.* Art. 8/2 AAOIFI SS 9.
476 *Cf.* Art. 8/3 AAOIFI SS 9.
477 Asser/Hijma 2013 (7-I*), no. 184.

to offer to purchase the tangible property. First, the promise of *wa'd* should not be a unilateral legal act (*eenzijdige rechtshandeling*) of the originator under Dutch law. The promise of *wa'd* is binding on the originator from an Islamic law perspective and, therefore, it should be documented as a contract under Dutch law so that the SPV can legally enforce it (*in rechte afdwingen*). Second, it cannot be a unilateral contract that gives the SPV a right to sell, also known as a sale option. A right to sell is a contractually provided entitlement (*wilsrecht*) that provides the entitled party (SPV) the right to sell the property at a certain date for a specified price.[478] According to Article 6:219 (3) DCC, a stipulation where one party binds itself to enter into a contract with another party at the latter's option is deemed to be an irrevocable offer (*onherroepelijk aanbod*). If the sale option were an irrevocable offer of the originator, sole acceptance by the SPV results in a contract of sale under Dutch law. This leads to a violation of Islamic law. Third, it is also not possible to document the promise of *wa'd* as a reciprocal contract (*wederkerige overeenkomst*) with the condition that the tangible property is sold and transferred to the originator at the occurrence of the maturity date of the *sukuk*. The conditional transfer of the right of ownership is in conflict with Islamic law.

5.3.3.2 Ijarah *Contract under Dutch Contract Law*

In the *sukuk al-ijarah*, the SPV (lessor) leases the underlying *halal* tangible property to the originator (lessee) pursuant to an *ijarah* contract: the lessor provides the lessee the right of use of a tangible property for a specified period against payment of an agreed lease price.[479] Article 7:201 DCC defines a rental agreement as an 'agreement where one party, the lessor, undertakes to provide another party, the lessee, the use of a tangible property or part of it and the lessee undertakes for a consideration'. The *ijarah* qualifies as a rental agreement within the meaning of Article 7:201 DCC.[480] According to the Islamic finance rules for the *ijarah* contract, the lessor as the owner of the tangible property should bear all the liabilities and risks attached to the ownership of the tangible property. This requirement does not raise any issues under Dutch law. The rules of book 7 DCC are directory rules (*regelend recht*), which means that parties can contractually agree on the distribution of liabilities and risks as they wish. In addition, there are (semi-) mandatory rules for rental agreements in book 7 DCC, but these rules do not prevent the originator and the SPV to contractually agree that the lessor as the owner of the tangible property

478 *Cf. Ibid.*
479 *Cf.* App. C AAOIFI SS 9.
480 Van Rossum 2009, p. 364. *Cf.* Art. 1 AAOIFI SS 9, which refers to the *ijarah* as an operational lease. An operational lease is often qualified as a rental agreement under Dutch law, *see* Van Hees 1997, pp. 24-28.

should bear all the liabilities and risks attached to the ownership of that tangible property.

Book 7 DCC provides semi-mandatory rules in relation to the obligations of the SPV as lessor in case of defects in the leased property.[481] Article 7:206 (1) DCC obliges the SPV to repair any defects at the request of the originator, unless it is impossible or it requires costs that in the circumstances concerned cannot reasonably be demanded from the SPV.[482] The originator is entitled to claim a proportionate reduction of lease payments, if a defect leads to impairment of enjoyment.[483] The SPV is, on the other hand, not responsible for minor repairs and not obliged to repair defects for occurrence of which the originator is liable towards the SPV, nor can the originator demand reduction of lease payments.[484] Furthermore, the SPV is obliged to pay damages if: (i) a defect occurs after the conclusion of the *ijarah* contract which is attributable to the SPV; (ii) a defect existed during the conclusion of the *ijarah* contract and the SPV knew or should have known about it; or (iii) in relation to which the SPV informed the originator that such defect did not exist.[485]

From an Islamic finance law perspective, these semi-mandatory rules of book 7 DCC do not raise any issues. Under Islamic finance law, the leased property remains the responsibility of the SPV as its owner/lessor, which means that the SPV is also responsible for major maintenance of the leased property and any defects that impair its enjoyment.[486] The SPV cannot exclude its liability towards the originator as lessee for any impairment of enjoyment as a result of defects, unless the defects can be attributed to the originator from an Islamic finance law perspective.[487]

The practical meaning of the semi-mandatory rules of book 7 DCC for the *ijarah* contract are not significant. The originator has been the owner of the tangible property before the sale and leaseback in the *sukuk al-ijarah* is concluded and it is aware of the state and the quality of the tangible property, even better than the SPV is. Furthermore, the originator will not request the SPV to repair any defects based on the semi-mandatory rules of book 7 DCC. The *sukuk al-ijarah* is a finance transaction and the SPV is solely incorporated by

481 The originator and the SPV cannot deviate from the rules of Arts. 7:206 (1) and (2), 7:207 and 7:208 DCC to the detriment of the originator, to the extent that the SPV knew or should have known about the defects at the moment of the conclusion of the *ijarah* contract. *See* Art. 7:209 DCC.

482 A defect is a state, quality or other circumstance that cannot be attributed to the originator, as a result of which the leased property cannot provide the originator the enjoyment of the property which the originator could expect from a well-maintained property of that kind, *see* Art. 7:204 (2) DCC.

483 Art. 7:207 (1) DCC.

484 Arts. 7:206 (2) and 7:207 (2) DCC.

485 Art. 7:208 DCC.

486 Arts. 5/1/5, 5/1/7 and 5/1/8 AAOIFI SS 9.

487 Arts. 5/1/5 and 5/1/6 AAOIFI SS 9.

the originator to facilitate this *sukuk* transaction. The originator will not claim a proportionate reduction of lease payments on the basis of the semi-mandatory rules of book 7 DCC either because a reduction of the lease payments may result in a reduction of the periodic payments to *sukuk* holders. This, in turn, could lead to the *sukuk* becoming due and payable under the terms and conditions of the *sukuk*.

> Article 7:230a DCC provides semi-mandatory eviction protection rules which parties cannot deviate from to the detriment of the lessee, in the case of lease of immovable property, not being residential premises within the meaning of article 7:233 DCC and not being commercial premises within the meaning of article 7:290 (2) DCC. There are also (semi-) mandatory rules for the lease of residential and commercial premises.[488] The rules addressed are not in conflict with Islamic finance law.

Besides the *ijarah* contract between the originator and the SPV, the originator and the SPV agree on the above discussed promise of *wa'd* which is a contract with the unilateral obligation of the originator to offer the purchase of the tangible property at the maturity date of the *sukuk* under Dutch law. The combination of both contracts raises the question whether the legal relationship between the SPV (as lessor) and the originator (as lessee) qualifies as hire purchase. Book 7A DCC contains mandatory rules for hire purchase agreements of movable property.[489] The IHPIPA provides mandatory rules for hire purchase of immovable property.[490] Articles 7A:1576h (1) DCC and 1 (1) IHPIPA define a hire purchase agreement as an instalment sale where parties agree that the ownership of the sold tangible property is not transferred by sole physical delivery, but only upon fulfilment of the suspensive condition of payment in full of whatever is due by the buyer under the sale contract.[491] A hire purchase agreement is, thus, an instalment sale with the reservation

488 *See* Arts. 7:232 *ff.* respectively 7:291 *ff.* DCC. In practice, the leased property in a sale and leaseback in a *sukuk al-ijarah* will often not be residential or commercial premises. The originator will, for example, sell and leaseback its office buildings in the *sukuk* transaction. Such immovable properties do not qualify as residential premises. The definition of 'commercial premises' in Art. 7:290 (2) DCC is used in a narrow sense and its scope is restricted to premises for operating retail business, restaurant business, handicraft business, etc., *see* Asser/Abas 2011 (5-IIA), nos. 247-251. For example, according to case law, office buildings of a bank do not qualify as commercial premises within the meaning of Art. 1624 former DCC (the predecessor of Art. 7:290 DCC), *see* Sub District Court of Heerlen 15 April 1981, *NJ* 1981, 438.

489 Art. 7A:1576a DCC. The mandatory rules of book 7A DCC are not applicable to immovable property, *see* Art. 7A:1576 (4) (a) DCC.

490 Art. 15 IHPIPA.

491 According to Art. 7A:1576 (1) DCC, an instalment sale is a purchase where the parties agree to payment of the purchase price in instalments, two or more of which will be due after physical delivery of the tangible property to the buyer. *See* Section 5.2.3 of this chapter.

of ownership. The *ijarah* contract is a rental agreement and not an instalment sale. It does not meet the description of Articles 7A:1576h (1) DCC and 1 (1) IHPIPA. The SPV provides the originator only the right of use of the tangible property. The right of ownership of the tangible property is not transferred with the *ijarah* contract or with the contract with the unilateral obligation to offer.

According to Articles 7A:1576h (2) DCC and 1 (2) IHPIPA, all agreements with the same essence as hire purchase, either made in the form of a rental agreement or in any other form or name, are considered a hire purchase agreement. Such agreement should have the essential elements of a hire purchase based on its statutory definition: (i) the sale price of the property is paid in two or more instalments; (ii) the property is delivered to the hire purchaser; and (iii) its right of ownership is transferred to the hire purchaser under the suspensive condition of payment in full of whatever is due.

> In *Dexia/Tuijl*, also known as *Dexia*, the Court of Appeal assessed whether contracts for securities leasing (*effectenlease*) could be qualified as agreements with the same essence as hire purchase according to article 7A:1576h (2) DCC.[492] The Court of Appeal assessed whether the sale price was paid in two or more instalments, whether the shares were delivered, and whether their ownership was transferred to the lessee under the suspensive condition of full payment of whatever was due.[493] The Dutch Supreme Court was required to rule, *inter alia*, on the question whether the shares were delivered to the lessee, where parties argued in Supreme Court appeal that the delivery of the shares was an essential element of the statutory definition of hire purchase and since the obligation to deliver the shares was missing in the contracts for securities leasing, these contracts could not be qualified as hire purchase.[494] The Dutch Supreme Court ruled that the shares were delivered and their ownership was transferred under a suspensive condition of full payment of whatever was due, upholding the view of the Court of Appeal.[495] The legal framework for the assessment of whether a contract has the same essence as hire purchase was whether such contract contained the essential elements of the statutory definition of hire purchase.

In addition to the elements in the statutory definition of hire purchase, the relation between (the sum of) the lease payments and the purchase price that has to be paid at the end of the lease period is a relevant element in assessing

492 Dutch Supreme Court 28 March 2008, *NJ* 2009, 578, with case note by Hijma, *see* paras. 2.6 and 2.11 ruling Court of Appeal.
493 *Ibid.*, *see* paras. 2.9-2.11 ruling Court of Appeal.
494 *Ibid.*, *see* para. 4.3.
495 *Ibid.*, *see* para. 4.4.

whether an agreement has the same essence as hire purchase.[496] If the lease payments for the lease of a property include not only a fee for the use of the property, but also parts of its purchase price, leaving only a symbolic part of the purchase price that has to be paid for the purchase of the property at the end of the lease period (possibly by exercising a purchase option), an indication is given for the qualification of a contract as hire purchase.

The *ijarah* contract between the originator and the SPV and its combination with a contract with the unilateral obligation of the originator to offer the purchase of the tangible property at the maturity date of the *sukuk* in the *sukuk al-ijarah* do not fall within scope of Articles 7A:1576h (2) DCC and 1 (2) IHPIPA. In both contracts, there is no obligation to transfer the right of ownership of the leased tangible property to the originator under the suspensive condition of payment in full of whatever is due. Pursuant to the *ijarah* contract, the SPV is obliged to provide the originator the right of use of the tangible property and the originator is obliged to pay rent. Pursuant to the contract with the unilateral obligation to offer, the originator is only obliged to offer to purchase the tangible property. The SPV is, however, not obliged to accept such offer. Although in practice the SPV might accept the offer of the originator (since it ensures that the initial sale price of the tangible property paid by the SPV to the originator is repaid to the SPV and, hence, the *sukuk* holders are ensured that the principal of the *sukuk* will be repaid), there is no legal obligation for the SPV to accept such offer and – what is in particular relevant with regard to hire purchase – there is no legal obligation to transfer the right of ownership of the tangible property from the SPV to the originator.

What is more, the lease payments in the *sukuk al-ijarah* do not contain parts of the purchase price of the tangible property. This factor, furthermore, substantiates that the *ijarah* contract and the contract to offer to purchase the tangible property in the *sukuk al-ijarah* do not qualify as hire purchase on the basis of Articles 7A:1576h (2) DCC and 1 (2) IHPIPA.[497] The lease payments consist of fees for the use of the tangible property, which will be paid through to *sukuk* holders as periodic returns on their investment. The lease payments do not contain parts of the purchase price. Pursuant to the promise of *wa'd*, the purchase price of the tangible property at the end of the lease period

496 Court of Appeal of Amsterdam 28 May 1975, *NJ* 1977, 460; District Court of 's-Hertogenbosch 13 June 1997, *NJ* 1998, 432; Court of Appeal of 's-Hertogenbosch 30 September 2008, *RI* 2008, 90. *See also* Van Hees 1997, pp. 29-39, with further references to case law and the literature.

497 Van Rossum 2009, p. 364. Van Rossum discusses Art. 7A:1576h (2) DCC in relation to the *ijarah wa-iqtina*. Strictly speaking, the *ijarah* in the *sukuk al-ijarah* does not qualify as an *ijarah wa-iqtina* because the *ijarah* in the *sukuk al-ijarah* is combined with a promise to purchase by the lessee (providing the lessor a 'sale option'), while the *ijarah wa-iqtina* is an *ijarah* combined with a promise to sell by the lessor (providing the lessee a 'purchase option'). For the discussion of the *ijarah* contract in light of Art. 7:1576h (2) DCC and Art. 1 (2) IHPIPA the difference addressed is, however, irrelevant.

(being the maturity date of the *sukuk*) is a substantial amount: it is equal to the purchase price of the tangible property paid by the SPV to the originator at the commencement of the *sukuk* transaction.[498] As addressed in the previous subsection, the purchase price of the tangible property paid by the SPV to the originator should be based on correct valuations.[499]

The result of the legal analysis above is that the *sukuk* holders are ensured that the principal of the *sukuk* will be repaid to them. The originator is obliged to offer to purchase the tangible property for its initial sale price (*i.e.* the price for which the tangible property was sold by the originator to the SPV). In the event of depreciation of the underlying tangible property during the period for which the *sukuk* were issued, the SPV will accept the offer of the originator and sell the tangible property (since it will receive a higher price than the market value of the tangible property at that moment). In the event of appreciation of the underlying tangible property, however, the SPV is free to sell the tangible property to another party. In such case it is conceivable that the originator purchases the tangible property for its market value (the offer of the originator to purchase the tangible property for its market value will not be based on the discussed promise of *wa'd*). Hence, the originator bears the downside of the fluctuation of the value of the underlying tangible property, while the SPV (and, eventually, the *sukuk* holders) enjoy only its upside. From a *Shari'ah* perspective, this is accepted by the *Shari'ah* scholars with the argument that the concept of profit-and-loss-sharing is not an essential element of the *ijarah*, but it is an essential element of partnership contracts such as the *musharaka*.[500] From a practical perspective, the originator should anticipate this risk. The originator could use tangible properties the value of which is less vulnerable to fluctuations in the *sukuk al-ijarah*.[501]

Concluding, the sale and leaseback in the *sukuk al-ijarah* can be structured under Dutch law. The title for the transfer of the tangible property in the sale and leaseback is not invalidated by the *fiducia* prohibition. The promise of *wa'd* provided by the originator to the SPV can be structured through a unilateral obligation to offer to purchase the tangible property. The *ijarah* contract qualifies as a rental agreement and the Islamic finance rules for the *ijarah* are not in conflict with the (semi-) mandatory rules for rental agreements in book 7 DCC. The mandatory rules for hire purchase are not applicable to the *sukuk*

498 *Offering Circular* PETRONAS Global Sukuk 2009, pp. 118-120; *Offering Circular* Qatar Global Sukuk 2003, pp. 3 & 18; *Offering Circular* DEWA Funding Sukuk 2008, pp. 16 & 78-79; *Offering Circular* 1 Malaysia Sukuk Global 2010, pp. 64-65.

499 *See* Section 5.3.2 of this chapter.

500 *See* Rule 5 AAOIFI Resolution of 2008; *see also* Section 4.3.3 of Chapter 4 and Section 5.3.3.1 of this chapter.

501 In Chapter 4 I discussed the type of assets that are often used in the *sukuk al-ijarah, see* Section 4.3.3 of Chapter 4.

al-ijarah because the *ijarah* and its combination with the unilateral obligation to offer do not qualify as hire purchase.

5.4 Concluding Remarks

In this chapter I assessed how the underlying Islamic finance contracts in the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah* can be structured under Dutch law. In this final subsection I will reflect on my findings with some concluding remarks. These concluding remarks are twofold: (i) I will summarise my findings; and (ii) I will arrive at a synthesis of some legal concepts that were discussed in this chapter under Islamic law and under Dutch law.

Summarising, all three types of *sukuk* transactions can be structured under Dutch law. The *musharaka* in the *sukuk al-musharaka* can be incorporated as a BV under Dutch corporate law. The objects of the *musharaka* BV should stipulate that it is a *Shari'ah*-compliant BV and the transfer of its shares should be excluded in its articles of association when the value of its tangible properties and services is less than 30% of its total assets value based on its annual accounts of that year. The *murabaha* in the *sukuk al-murabaha* occurs through a sale and transfer of the tangible property from the third-party seller to the SPV, followed by an instalment sale and transfer of it from the SPV to the originator with the reservation of a security right for the SPV under Dutch law. The sale and leaseback in the *sukuk al-ijarah* can be structured through an 'actual transfer' of the tangible property by the originator to the SPV, followed by a leaseback from the SPV to the originator pursuant to an *ijarah* that qualifies as a rental agreement under Dutch law. The originator and the SPV also conclude a promise of *wa'd* that qualifies as a contract with a unilateral obligation of the originator to offer to repurchase the tangible property at the end of the lease under Dutch law.

I arrive at a synthesis of some Islamic and Dutch legal concepts discussed in this chapter. The transactions discussed in this chapter relate to the position of the right of ownership under Islamic and Dutch property law. Within Islamic property law, the right of ownership (*milk*) is the complete and exclusive right of an owner (*malik*) to dispose of tangible property with the exclusion of other parties. It is not possible to condition the exclusive right of an owner under Islamic law: it is not possible to transfer the right of ownership of a tangible property under the suspensive condition of payment of an amount, as discussed in relation to the *sukuk al-murabaha* in Subsection 5.2. In the same line of thought, a fiduciary security transfer where the right of ownership of an owner is restricted to a right of recourse which can be enforced upon the condition that the transferor defaults on a payment is not possible, as discussed in relation to the *sukuk al-ijarah* in Subsection 5.3. However, it

is possible to create a security right on a tangible property. It is also possible to transfer a right of ownership with the reservation of a security right under Islamic law (a 'fiduciary pledge' under Islamic law). If parties to a transaction wish to provide 'collateral' in the form of a right of ownership, they should be aware that they unconditionally transfer the right of ownership of the tangible property, which means that they provide the transferee more than a security right.

Dutch law shows a similarity with Islamic law. Based on the *fiducia* prohibition of Article 3:84 (3) DCC and on the landmark case *Sogelease*, Dutch law does not accept fiduciary security ownership (*fiduciaire zekerheidseigendom*). The parties to a transaction should either transfer the complete right of ownership of a property or create a security right to secure a claim under Dutch law. If they, nonetheless, use the right of ownership to secure a claim, they transfer the complete right of ownership and give the transferee more than a security right. At the same time, Dutch law shows a difference with Islamic law: Dutch law has accepted conditional ownership (*voorwaardelijke eigendom*). An example of conditional ownership is the reservation of ownership (*eigendomsvoorbehoud*). In essence, the reservation of ownership is also a form of security ownership (*zekerheidseigendom*). The approach of the Dutch legislature towards the reservation of ownership has been pragmatic in order to meet the needs of commercial and financial transactions in practice.

Another observation with regard to the right of ownership relates to the limitation of its scope to tangible property (*ayn*) under Islamic law. The trade in intangible properties, *i.e.* claims, (*bay' al-dayn*) is prohibited if the claims are traded for another price than their face value. In commercial transactions, claims are rarely traded at face value, so the principle of *bay' al-dayn* practically results in the prohibition of the trade in claims. The trade in the shares of a stock company are, nonetheless, accepted under Islamic finance law with the reasoning that the shareholders of a stock company are deemed its owners. When they sell their shares, they sell their ownership in the assets of the stock company. This also explains the restriction of the main activities of a *musharaka* stock company to tangible properties, as was discussed in relation to the incorporation of a *musharaka* BV in Subsection 5.1. The approach of Islamic scholars is, however, inconsistent with the acceptance of the concept of legal personality for a *musharaka* stock company under Islamic law. A *musharaka* stock company acts in its own legal capacity and is the owner of the tangible properties it holds under Islamic finance law. Its shareholders have only financial rights and controlling rights.

The approach of Islamic scholars towards conventional shares shows a form of modern day *ijtihad* (as discussed in Chapter 2) within Islamic finance law: independent reasoning by Islamic scholars through which modern day concepts have been given place within Islamic law by way of an exception

to the classical doctrine of Islamic (property) law. Consequently, the Islamic rules are adapted to modern day concepts. In addition, the approach of Islamic scholars also corresponds to the economic reality in society. The concept of legal personality for a company is a legal fiction. The reality is that shareholders enjoy the profits and bear the losses realised by a company and economically act as the owners of its assets.

The addressed inconsistency in the Islamic legal system is taken a step further with the tradability of the *sukuk al-musharaka*: securities (*sukuk*) issued over securities (shares in a *musharaka* BV). The inconsistency is stressed where the shares of the *musharaka* cannot be traded when the value of its tangible properties and services is less than 30% of its total assets value, while the *sukuk* remain tradable in such event. Strictly speaking, one might argue that acceptance of the tradability of the *sukuk al-musharaka* results in a violation of the ban on *riba*, more specifically the ban on the *bay' al-dayn*. The *sukuk al-musharaka* is, nonetheless, one of the 14 *sukuk* structures accepted by the AAOIFI. Two points deserve consideration in this regard. First, the acceptance of the tradability of the *sukuk al-musharaka* shows the significance of another explication of the prohibition of *riba*: the emphasis on the concept of profit-and-loss-sharing. The significance of the profit- and loss-sharing nature of the *sukuk al-musharaka* also returns in the ban on preference shares, as discussed in Subsection 5.1. Hence, the prohibition of *riba* mainly stands on two pillars: (i) the emphasis on the concept of profit-and-loss-sharing; and (ii) the prohibition on the trade in claims (*bay' al-dayn*). Second, the tradability of securities issued over securities raises the question whether *sukuk* issued over underlying *sukuk* are tradable. So far, this has not been accepted by the AAOIFI.

6 The Rights of *Sukuk* Holders in *Sukuk* Transactions under Dutch Law

In this chapter I assess the rights of the *sukuk* holders under Dutch law. The *sukuk* holders subscribe to *sukuk* issued by an SPV. The SPV, in turn, concludes an Islamic finance contract with the party requiring funding, the originator. The SPV connects the *sukuk* holders as financiers to the transactions of the Islamic finance contracts. This occurs through a securitisation process called *tawreeq*. In the previous chapter I assessed the underlying Islamic finance contracts of the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah* under Dutch law. The focus of this chapter is on the legal position of the *sukuk* holders in these *sukuk* structures. I will first discuss the Islamic finance rules for *tawreeq* that should be respected in all three *sukuk* structures in order to acquire the approval of a *Shari'ah* supervisory board (Section 6.1). Next, those Islamic finance rules are assessed under Dutch corporate, property and bankruptcy law (Section 6.2). This enables me to answer the question whether *sukuk* can be structured under Dutch law.

6.1 Islamic Finance Rules for the Securitisation Process Called *Tawreeq*

The originator incorporates an SPV as part of the securitisation process called *tawreeq*. The SPV acquires the underlying property of the *sukuk* transaction and becomes its owner. The SPV issues *sukuk*. From an Islamic finance law perspective, the *sukuk* should give the *sukuk* holders the 'ownership' of the underlying property of the *sukuk* transaction. The right of ownership of the underlying property does not have to be proprietarily transferred to the *sukuk* holders. Islamic finance law requires that the *sukuk* entitle the *sukuk* holders to financial rights, which are based on the returns on the underlying property. The terms and conditions of the *sukuk* stipulate the conditions of the *sukuk* issuance and the rights of the *sukuk* holders.[502] Pursuant to the terms and conditions of the *sukuk*, the *sukuk* holders should have claims on the SPV for

502 *Offering Circular* TID Global Sukuk 2006, pp. 57-72; *Offering Circular* JAFZ Sukuk 2007, pp. 73-89; *Offering Circular* NICBM Sukuk 2006, pp. 13-26; *Offering Circular* URC Sukuk 2007, pp. 22-39; *Offering Circular* PETRONAS Global Sukuk 2009, pp. 86-107; *Offering Circular* Qatar Global Sukuk 2003, pp. 10-23; *Offering Circular* DEWA Funding Sukuk 2008, pp. 27-40; *Offering Circular* 1 Malaysia Sukuk Global 2010, pp. 27-53.

payment of amounts equal to revenues generated with the underlying property. Economically, the *sukuk* holders become the owners of the property.

> In the *sukuk al-musharaka* the underlying properties are shares in a Dutch BV.[503] In the *sukuk al-murabaha* the underlying property is a claim on the originator for the payment of the purchase price of the tangible property that is sold by the SPV to the originator.[504] In the *sukuk al-ijarah* the underlying property is a tangible property that is the subject-matter of the sale and leaseback transaction between the originator (transferor/lessee) and the SPV (transferee/lessor).[505] The SPV provides the *sukuk* holders the economic ownership of the underlying property through *tawreeq*. The *sukuk* holders hold *sukuk* certificates that represent their ownership in the sense that the financial rights and obligations represented by those *sukuk* are the returns and losses on the underlying property. The *sukuk* holders as economic owners of the underlying properties can trade their *sukuk* certificates if the underlying properties are (deemed) tangible properties. Therefore, *sukuk al-musharaka* and *sukuk al-ijarah* are tradable in secondary markets.[506] *Sukuk al-murabaha* are, on the other hand, not tradable.[507] In this chapter I do not assess the tradability of *sukuk* certificates from one investor to another under Dutch law.

In this chapter I assess the process of *tawreeq* under Dutch corporate, property and bankruptcy law. In Chapter 4 I formulated three Islamic finance rules for *tawreeq,* which should be taken into consideration when structuring *sukuk* under Dutch law:

1. the incorporation of an SPV;
2. the transfer of the right of ownership of the underlying property to the SPV; and
3. the issuance of *sukuk* certificates that economically represent the ownership of the underlying property, that is, the financial rights and obligations represented by the *sukuk* should be based on the returns and losses on the underlying property.

These rules are my theoretical framework for an assessment under Dutch law. The Islamic finance rules should be met in order to acquire the approval of a *Shari'ah* supervisory board for the qualification of the securities as *sukuk*.

503 *See* Section 5.1 of Chapter 5.
504 *See* Section 5.2 of Chapter 5.
505 *See* Section 5.3 of Chapter 5.
506 Strictly speaking, the underlying properties in the *sukuk al-musharaka* are not tangible properties. The underlying properties that the SPV holds are shares in a *musharaka* BV. Nonetheless, Islamic scholars have accepted the tradability of *sukuk al-musharaka*. *See* Sections 5.1 and 5.4 of Chapter 5.
507 The *sukuk al-murabaha* are often offered to a closed circle of investors through private placements because these *sukuk* are not tradable. *See* Section 1.4 of Chapter 1.

Otherwise, a *Shari'ah* supervisory board may not approve the *sukuk* structure which means that the securities are not *Shari'ah*-compliant and cannot be offered as *sukuk* in financial markets.

6.2 The Securitisation Process Called *Tawreeq* and the Rights of the *Sukuk* Holders under Dutch Law

In this section the three Islamic finance rules for *tawreeq* are assessed under Dutch law. The first two Islamic finance rules ensure that there is a separation of the underlying property from the patrimony of the originator. According to the first Islamic finance rule, an SPV should be incorporated. The SPV is a separate legal entity with its own patrimony. There are no *Shari'ah* requirements for the legal form of the SPV. The SPV has the sole purpose of facilitating the *sukuk* transaction. In most – if not all – *sukuk* structures, a new SPV is incorporated for each new *sukuk* structure.[508] In this section I assess the legal form of the SPV under Dutch corporate law (Section 6.2.1).

In the literature, it has been suggested that the use of a single SPV for more *sukuk* issuances is preferable, in order to reduce transaction costs.[509] Nonetheless, the incorporation of a new SPV for each *sukuk* issuance serves valid purposes. First, it ensures that there is a separation of funds, which is in particular relevant in the case of bankruptcy of the SPV. Such purpose is especially evident in jurisdictions such as the Netherlands where a debtor cannot divide his patrimony into separate (trust) funds and, consequently, cannot (i) separate property from its private bankruptcy estate or (ii) keep a part of its patrimony separate for a specific group of its creditors.[510] Separating the underlying property of the *sukuk* transaction from the bankruptcy estate of the SPV may, on the other hand, be less problematic in jurisdictions where it is possible to create a trust over the underlying property, since a trust property does not fall into the bankruptcy estate of the trustee. Second, if a single SPV is used for each *sukuk* issuance, it is more evident that that SPV is managing the property of that specific *sukuk* transaction for the *sukuk* holders of the *sukuk* transaction concerned. As a result, the properties of several *sukuk* holders are not commingled and possible discussions between different pools of *sukuk* holders about the question which underlying property is managed by the SPV for which pool of *sukuk* holders are avoided.

508 *Offering Circular* TID Global Sukuk 2006, p. 17; *Offering Circular* JAFZ Sukuk 2007, p. 34; *Offering Circular* NICBM Sukuk 2006, pp. 30-31; *Offering Circular* URC Sukuk 2007, p. 40; *Offering Circular* PETRONAS Global Sukuk 2009, p. 82; *Offering Circular* Qatar Global Sukuk 2003, pp. 27-28; *Offering Circular* DEWA Funding Sukuk 2008, pp. 44-45; *Offering Circular* 1 Malaysia Sukuk Global 2010, pp. 59-60.

509 *See* McMillen 2008, p. 735.

510 Art. 3:276 DCC.

According to the second Islamic finance rule, the originator should transfer the right of ownership of the underlying property to the SPV. The second Islamic finance rule for *tawreeq* was discussed for each *sukuk* structure in the previous chapter.

The third Islamic finance rule relates to the transfer of the economic ownership of the underlying property of the *sukuk* transaction by the SPV to the *sukuk* holders. The SPV issues *sukuk* certificates. Pursuant to the terms and conditions of the *sukuk*, the financial rights and obligations represented by the *sukuk* should be based on the returns and losses on the underlying property. In this section I will also assess how the 'ownership' of the underlying property is transferred by the SPV to the *sukuk* holders under Dutch law (Section 6.2.2).

The first two Islamic finance rules for *tawreeq* ensure that there is a separation of the underlying property from the patrimony of the originator. A bankruptcy is the litmus test for the question whether property has been separated from the patrimony of the originator. Therefore, the bankruptcy of the originator is analysed in Section 6.2.3. There are no *Shari'ah* requirements that need to be taken into consideration in this regard. The bankruptcy of the originator will be analysed under Dutch law.

6.2.1 The Legal Form of the SPV under Dutch Corporate Law

The SPV is incorporated to facilitate the *sukuk* transaction and there are no *Shari'ah* requirements for its legal form. In practice, an orphan structure can be used: the SPV is incorporated as a limited liability company and its shares are held by another party.[511] An orphan structure can also be used under Dutch corporate law. The SPV can be incorporated as a Dutch BV that issues the *sukuk*. The shares of the Dutch BV can be held by a Dutch foundation (*stichting*). The objects clause of the foundation will limit its objects to the sole purpose of holding the shares of the BV.

It is also possible to incorporate the SPV itself as a foundation.[512] In 2004, the German state Saxony-Anhalt issued the first European *sukuk*. The SPV was incorporated as a Dutch foundation.[513] It has been mentioned that the use of a foundation as an SPV is in line with Dutch market practice in structured asset finance transactions.[514] In the literature, the use of a foundation as an

511 *Offering Circular* TID Global Sukuk 2006, p. 17; *Offering Circular* JAFZ Sukuk 2007, p. 34; *Offering Circular* NICBM Sukuk 2006, pp. 30-31; *Offering Circular* URC Sukuk 2007, p. 40; *Offering Circular* DEWA Funding Sukuk 2008, pp. 44-45.
512 Salah 2010a, pp. 46-48.
513 *Offering Circular* Saxony-Anhalt Sukuk 2004, p. 26.
514 Muller & Hooft 2008.

SPV is preferred over the use of a BV for the following two reasons.[515] First, a foundation is a legal entity that has no members.[516] Unlike a BV, there can be no tension between the interests of the legal entity itself and the interests of its shareholders because a foundation has no shareholders as such.[517] It has only a managing board. Second, a foundation aims to realise objects as defined in its articles of association with capital provided for that purpose.[518] As appears from its statutory definition, the foundation is meant to be incorporated with a focus on a specific purpose such as the custody of assets.[519]

> According to article 2:285 (3) DCC the objects of a foundation cannot stipulate that payments are made to its founders or to those who are part of its corporate bodies. The objects of a foundation can also not stipulate that payments are made to others, unless such payments have an idealistic or societal purpose.[520] The rationale behind this provision is to make a distinction between a foundation and a corporation.[521] The foundation is not a form of enterprise. Unlike a BV, a foundation, for example, cannot have the object of making profit distributions to investors in its capital.[522] This, however, does not mean that a foundation cannot serve commercial purposes.[523] A foundation may, for example, be used for the custody and management of assets, even in commercial transactions such as the issuance of depositary receipts for shares (*certificering van aandelen*)[524] or conventional securitisations.[525] The payments to *sukuk* holders in *sukuk* transactions are pursuant to an agreement, *i.e.* the terms and conditions of the *sukuk*. The payments to *sukuk* holders do not occur pursuant to the objects of the foundation as stipulated in its articles of association. In the literature, it is broadly accepted that payments pursuant to an agreement for valuable consideration (*overeenkomst onder bezwarende*

515 *Ibid.* The use of a foundation as an SPV, instead of a BV, is also preferred in conventional securitisations, *see* Van Houte 2001, pp. 76-81. Often, tax advantages of a foundation compared to a BV are addressed. Tax law falls outside the scope of this research and will not be discussed. For more on the tax law aspects of the use of foundations as SPVs, *see* Muller & Hooft 2008; Wessels, Schwarz & Van de Streek 2002, p. 210; Van Houte (*Financiering, belegging en verzekering: Convergentie van financiële markten*) 2006, p. 289; Van Houte 2009a, pp. 303-314; Van Houte 2009b, pp. 87-98.

516 Art. 2:285 (1) DCC.

517 Van Houte (*Financiering, belegging en verzekering: Convergentie van financiële markten*) 2006, p. 289.

518 Art. 2:285 (1) DCC.

519 Van Houte 2001, pp. 76-81.

520 Art. 2:285 (3) DCC.

521 Asser/Van der Grinten & Maeijer 1997 (2-II), no. 471.

522 Pitlo/Raaijmakers 2006, p. 665.

523 Aertsen 2004, p. 116; Dijk & Van der Ploeg 2007, pp. 20-21.

524 For more on issuing depositary receipts for shares, *see* Section 6.2.2.3 of this chapter.

525 *See* Van Houte 2001, pp. 76-81. For more on conventional securitisations, *see* Schwarcz, Markell & Broome 2004; Schwarcz 2007; Schwarcz 2008; Schwarcz 2009, pp. 211-268; Wood 2008, Chapters 28 & 29. For more on conventional securitisations and Dutch law, *see* Rongen 2012; Vriesendorp & Wibier 2009, pp. 2-8; Wibier 2009a, pp. 1198-1207; Wibier 2011a. For a comparison of conventional securitisations with Islamic securitisations, *see* Wibier & Salah 2010, pp. 1738-1746; Wibier & Salah (*Islamic Finance and the Influence of Religion on the Law*) 2011.

> *titel*) do not fall within the scope of the prohibited payments of article 2:285 (3) DCC.[526] Furthermore, in *sukuk* transactions, the payments to *sukuk* holders are not in conflict with the rationale of article 2:285 (3) DCC. The foundation is not making profit as a corporation, which it pays (as a form of dividends) to the *sukuk* holders. The foundation does not make profit itself; it only pays through to the *sukuk* holders amounts it receives from the *musharaka* BV and the originator.

The activities of the SPV should be restricted, regardless of whether the SPV is incorporated as a BV or as a foundation. The objects of the SPV as stipulated in its articles of association should stipulate that the SPV has the sole purpose of facilitating the *sukuk* transaction so that the SPV cannot undertake other activities than those necessarily required to facilitate the *sukuk* transaction. As a result, the risk of bankruptcy of the SPV is mitigated, making the SPV a bankruptcy-remote vehicle.[527]

> In addition to a restricted description of its objects, other measures can be taken to make the SPV a bankruptcy-remote vehicle, such as measures to mitigate the risk of filing for a bankruptcy proceeding by the SPV itself or by its creditors, measures to mitigate external influence on the SPV (through unwanted control over its shares or through bankruptcy of other parties triggering the bankruptcy of the SPV) or measures to safeguard its patrimony.[528]

A transgression of the objects (*doeloverschrijding*) of the SPV results in an *ultra vires* act. According to Article 2:7 DCC, a legal act of a legal entity is voidable (i) if the legal act leads to a transgression of the objects of the legal entity and (ii) if the counterparty knew this or could have known this without own research. The voidability of an *ultra vires* claim has external force. This means that it affects the power of representation of the managing board of the SPV. According to Article 2:7 DCC, only the SPV can invoke the *ultra vires* claim. If the managing board of the SPV refuses to invoke such claim, its managing board can be replaced by a new managing board.[529]

526 Asser/Van der Grinten & Maeijer 1997 (2-II), no. 472; Overes (GS Rechtspersonen, Art. 2:285 DCC) 2012, no. 7; Dijk & Van der Ploeg 2007, pp. 20-21; Pitlo/Raaijmakers 2006, p. 665.

527 The bankruptcy-remoteness of the SPV is one of its most significant features, *see* DeLorenzo & McMillen (*Islamic Finance: The Regulatory Challenge*) 2007, pp. 177-178; McMillen 2006, pp. 164-166; McMilen 2007, pp. 453-455; IMF Policy Discussion Paper 2008, p. 14; IMF Working Paper 2007, p. 28; Adam *(Advances in Islamic Economics and Finance, Volume 1, Proceedings of the 6th International Conference on Islamic Economics and Finance)* 2005, pp. 383-385; Abdel-Khaleq & Richardson 2007, pp. 418-419.

528 For a discussion of such measures for SPVs in conventional securitisations under Dutch law, *see* Rongen 2012, pp. 151-184.

529 If the SPV is a BV, its shareholder (*i.e.* the foundation holding its shares for the purpose of facilitating the *sukuk* transaction) can replace the managing board. *See* Art. 2:244 DCC. If the SPV is a

> For the question whether a legal act leads to transgression of the objects of the SPV, its objects as defined in its articles of association is not decisive.[530] All circumstances should be taken into consideration.[531] The knowledge of the transgression of the objects is required at the moment of performance of the legal act.[532] The sole publication of the articles of association of the foundation is not sufficient to prove the required knowledge of the counterparty.[533] According to case law of the Dutch Supreme Court, however, the articles of association do have a key role in relation to the required knowledge of transgression of the objects: the counterparty of the foundation bears the risk of unfamiliarity with the objects of the SPV as stipulated in its articles of association. If the counterparty of the SPV, after consulting the articles of association of the SPV, should have known that a legal act results in a transgression of its objects, the counterparty cannot rely on his unfamiliarity with the objects of the SPV.[534]

Finally, Dutch corporate law provides specific rules for a foundation that make the incorporation of an SPV as a foundation attractive. According to Article 2:291 (2) DCC, the managing board of a foundation only has the power to enter into certain specified acts when such power is granted to it by the articles of association of the foundation.[535] The articles of association of the foundation can restrict the power of representation of its managing board with regard to the acts mentioned in Article 2:291 (2) DCC.[536] If the managing board disregards the articles of association and, nonetheless, performs such legal acts, those legal acts will be void.[537] It is possible to restrict with external effect incurring of debts and liabilities that are not part of the *sukuk* transaction, granting security for debts not related to the *sukuk* transaction and transfer or encumbrance of immovable property outside the scope of the *sukuk* transaction. The latter is relevant with regard to the *sukuk al-murabaha* and the *sukuk al-ijarah*

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foundation, the *sukuk* holders as interested parties within the meaning of Art. 2:298 (1) DCC can request the court to dismiss the managing board of the foundation and appoint a new managing board.

530 Dutch Supreme Court 16 October 1992, *NJ* 1993, 98, with case note by Maeijer, para. 3.2.

531 *See* Dutch Supreme Court 7 February 1992, *NJ* 1992, 438, with case note by Maeijer, para. 3.3; Dutch Supreme Court 16 October 1992, *NJ* 1993, 98, with case note by Maeijer, para. 3.2; Dutch Supreme Court 20 September 1996, *NJ* 1997, 149, para. 3.4.

532 *See* Huizink (GS Rechtspersonen, Art. 2:7 DCC) 2005, no. 4.

533 *See* Asser/Van der Grinten & Maeijer 1997 (2-II), no. 75; Huizink (GS Rechtspersonen, Art. 2:7 DCC) 2005, no. 8.

534 Dutch Supreme Court 15 June 1973, *NJ* 1973, 469, with case note by Wachter.

535 The power of representation of the managing board of a foundation is unrestricted and unlimited, unless the law provides otherwise, *see* Art. 2:292 (3) DCC. Dutch corporate law has statutory restrictions which are specifically applicable to foundations. *See* Asser/Van der Grinten & Maeijer 1997 (2-II), nos. 484-485; *cf.* Asser/Van der Grinten & Maeijer 1997 (2-II), no. 319.

536 Parliamentary History, Act Implementing Book 2 DCC 1977, pp. 1206-1208.

537 Asser/Van der Grinten & Maeijer 1997 (2-11), no. 320. The foundation has the power to invoke the restriction of its power of representation, *see* Art. 2:292 (3) DCC.

where the underlying property can be immovable property. Article 2:291 (2) DCC, thus, further promotes the bankruptcy-remoteness of the SPV.

6.2.2 The Ownership of *Sukuk* Holders in Underlying Properties of *Sukuk* Transactions under Dutch Law

The SPV issues *sukuk*. The *sukuk* should give the *sukuk* holders the 'economic ownership' of the underlying property of the *sukuk* transaction. Pursuant to the terms and conditions of the *sukuk*, the *sukuk* holders should have financial rights that entitle them to profits generated with the underlying property. However, the right of ownership of the underlying property does not have to be proprietarily transferred to the *sukuk* holders. In practice, the SPV often creates an English law trust over the underlying property of a *sukuk* transaction (the trust property).[538] As a result, the SPV is the legal owner of the trust property and the *sukuk* holders are the beneficial owners of the trust property. The creation of an English law trust is not required under Islamic finance law, but its use is attractive in *sukuk* transactions because the trust property does not fall into the bankruptcy estate of the SPV in case of its bankruptcy.[539]

It is not possible to create a trust under Dutch law.[540] There are three impediments for the creation of a trust. First, Article 3:84 (3) DCC declares the title for the transfer of a property invalid if it is intended for security purposes (*fiducia cum creditore*) or if it does not have the purpose of bringing the property into the patrimony of the transferee (*fiducia cum amico*). The creation of a trust is a form of the prohibited *fiducia cum amico* because the trust property does not form part of the bankruptcy estate of the trustee.[541] Second, according to the *paritas creditorum* in Article 3:277 (1) DCC, creditors have an equal right amongst themselves to be paid from the net proceeds of the properties of their

538 *Offering Circular* TID Global Sukuk 2006, pp. 61-62; *Offering Circular* JAFZ Sukuk 2007, pp. 75-76; *Offering Circular* NICBM Sukuk 2006, pp. 16-17; *Offering Circular* URC Sukuk 2007, pp. 25-26; *Offering Circular* PETRONAS Global Sukuk 2009, pp. 93-94; *Offering Circular* Qatar Global Sukuk 2003, pp. 14-15; *Offering Circular* DEWA Funding Sukuk 2008, p. 31; *Offering Circular* 1 Malaysia Sukuk Global 2010, p. 41.

539 *See* Section 4.2.2 of Chapter 4.

540 Aertsen 2004, pp. 1-5; Wibier 2011b, pp. 37-38. Although The Hague Convention on the Law Applicable to Trusts and on Their Recognition (Hague Trust Convention) requires the Netherlands to recognise foreign law trusts that have been validly created under such foreign law, it does not introduce the trust into domestic Dutch law.

541 According to the Dutch Supreme Court, a transaction where one party has the complete right of ownership of a property, while another party only has contractual rights on the property is not in conflict with the closed legal system of Dutch property law, *see* Dutch Supreme Court 19 May 1995, *NJ* 1996, 119, with case note by Kleijn/*AA* 1995, 11, with case note by Vriesendorp, para. 3.6. In the case of a trust, however, the beneficiaries seem to have an interest in the trust property that cannot be qualified as contractual rights only under Dutch law, *see* Hoppenreijs & Vriesendorp (*Verkenningen op de grens van burgerlijk recht en belastingrecht: Opstellen over (fiscaal) ondernemingsrecht, erfrecht en insolventierecht*) 2000, pp. 57-58.

debtor, after payment of the costs of execution, in proportion to their claims, except for the causes of preference recognised by law. The creation of a trust provides a cause of preference not recognised by law because the beneficial ownership of *sukuk* holders is not affected by the bankruptcy of the trustee as the legal owner of the trust property. Third, Article 3:276 DCC states that unless otherwise provided by law or contract, a creditor can take recourse for his claim against all the properties of his debtor. The Dutch Supreme Court ruled that it is only possible to make an exception to Article 3:276 DCC if this is provided by the law.[542] The creation of a trust violates this rule because the creditors of a trustee cannot take recourse for their claims against the trust property in the event of bankruptcy of the trustee.[543]

> The Netherlands is party to The Hague Convention on the Law Applicable to Trusts and on Their Recognition (Hague Trust Convention). As a party to the Hague Trust Convention, the Netherlands could be obliged to recognise certain aspects of a trust created under English law in *sukuk* transactions (although this is arguable in this study based on article 13 of the Hague Trust Convention that mentions that no state shall be bound to recognise a trust the significant elements of which are more closely connected with a state that does not have a trust because this study is based on the assumption that a Dutch legal entity initiates a *sukuk* transaction through the use of an underlying property located in the Netherlands, where Dutch law governs all transaction documents). However, as mentioned in chapter 1, private international law falls outside the scope of this research.[544] Therefore, the Hague Trust Convention is not discussed in this book.

In civil law jurisdictions such as the Netherlands where the trust is unknown, the question arises in what way the 'economic ownership' of the *sukuk* holders can be realised and protected against a possible bankruptcy of the SPV.[545] In the following subsections I discuss the 'economic ownership' of the *sukuk* holders under Dutch law (Section 6.2.2.1). I then assess the creation of security rights to secure their position in the event of bankruptcy of the SPV under Dutch law. I assess the possibility to provide the *sukuk* holders security rights through a collective security arrangement (*collectieve zekerheidsarrangement*) (Section 6.2.2.2) and through the statutory joint right of pledge of Article

542 Dutch Supreme Court 13 June 2003, *NJ* 2004, 196, with case note by Kleijn, para. 3.3.4.

543 Another view on Art. 3:276 DCC is that it is in fact a form of a statutory trust under Dutch law, *see* Vriesendorp (*Trust en onderneming*) 2003, pp. 151-161.

544 *See* Section 1.3 of Chapter 1.

545 The French legislature, for example, was contemplating the introduction of the *fiducie* (the French equivalent of an English law trust) to facilitate *sukuk* transactions. For more on the French *fiducie*, *see* Report of Brunel No. 1901, Assemblée Nationale, 2009; Report of Marini No. 442, Sénat, 2009; *cf.* Kopalit 2009, pp. 701-706.

3:259 DCC in the case of issuance of depositary receipts for shares (*certificaten van aandelen*) (Section 6.2.2.3). Finally, with regard to the *sukuk al-musharaka*, I will also assess the possibility to provide the *sukuk* holders the economic ownership of the shares in the *musharaka* BV through the issuance of non-voting shares (*stemrechtloze aandelen*) (Section 6.2.2.4). Hence, the focus of the following subsections is on the legal relationship between the SPV and the *sukuk* holders as indicated in Figures 1, 2 and 3 (except for Subsection 6.2.2.4 where the *musharaka* BV will issue non-voting shares to the *sukuk* holders directly and no SPV is incorporated).

Figure 1 Rights of *sukuk* holders in *sukuk al-musharaka* under Dutch law

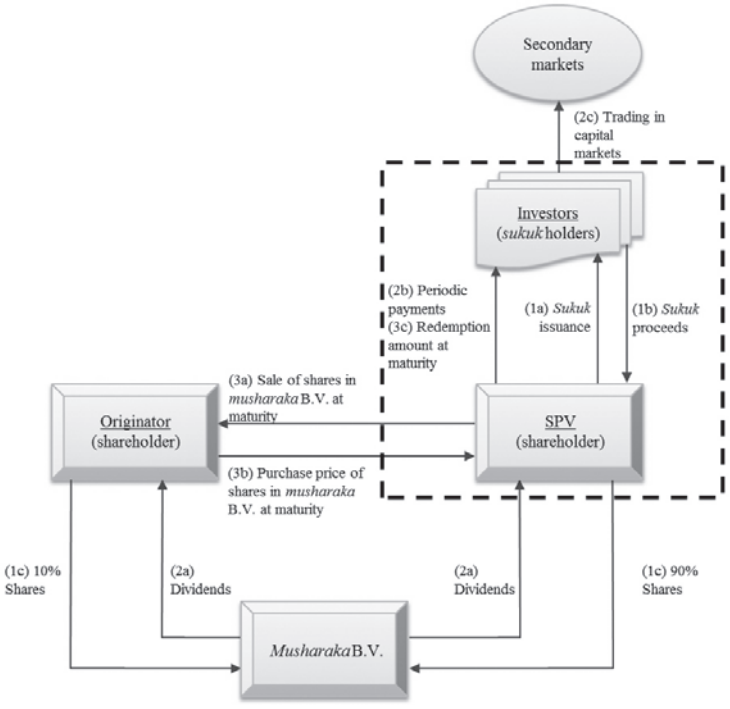


Figure 2 Rights of *sukuk* holders in *sukuk al-murabaha* under Dutch law

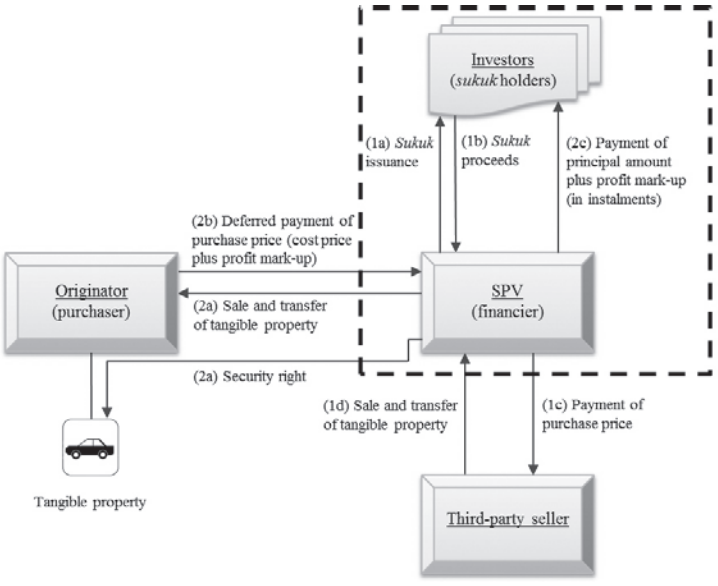
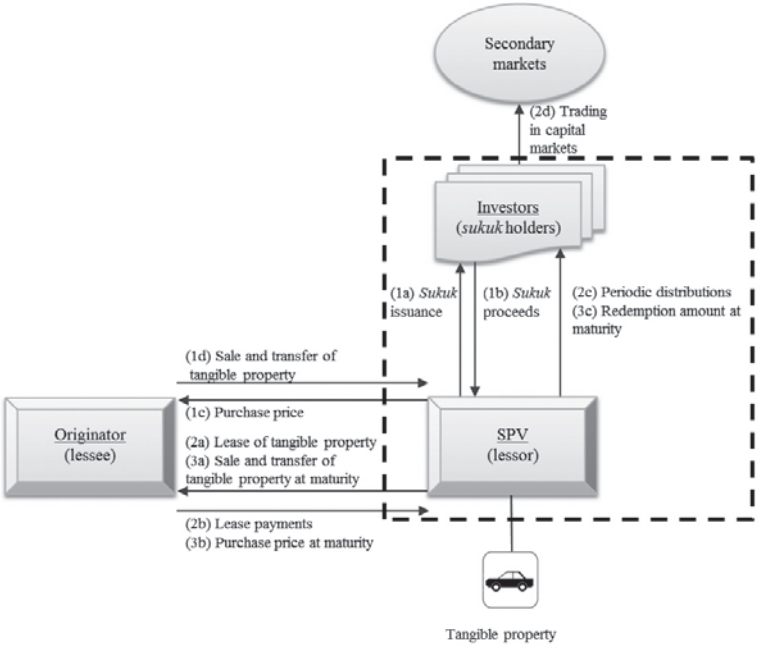


Figure 3 Rights of *sukuk* holders in *sukuk al-ijarah* under Dutch law



6.2.2.1 *The Economic Ownership of* Sukuk *Holders under Dutch Property Law*

The terms and conditions of the *sukuk* form the agreement between the SPV as the issuer of the *sukuk* and the *sukuk* holders as the subscribers to the *sukuk* under Dutch law.[546] The terms and conditions of the *sukuk* should stipulate that the *sukuk* holders are the economic owners of the underlying property of the *sukuk* transaction, that is, that the *sukuk* holders have provided capital so that the SPV can acquire the property and that the *sukuk* holders are entitled to the financial benefits realised with that property. The *sukuk* holders have financial rights towards the SPV, *i.e.* contractual claims for payment of amounts pursuant to the terms and conditions of the *sukuk*. The legal relationship between the SPV and the *sukuk* holders is contractual under Dutch law. As a result, the SPV remains the owner of the underlying property in the *sukuk* transaction and the *sukuk* holders acquire its economic ownership (*economische eigendom*) under Dutch law.

Under Dutch law the term 'economic ownership' refers to a bundle of contractual rights and obligations in relation to a property.[547] The legal owner of a property transfers the benefits and expenditures of that property to the economic owner, pursuant to an agreement between both parties.[548] The term 'economic ownership' does not have a statutory basis under Dutch law. According to the Dutch Supreme Court, economic ownership is not ownership as known under Dutch property law.[549] It is a summary description without an independent meaning of the legal relationship between the parties that have established the economic ownership.[550] Dutch legal practice felt the need to deem economic ownership as a sort of unity.[551]

> In the course of the preparations of book 5 of the Dutch Civil Code, the question was raised whether the distinction between legal ownership and economic

546 In the Dutch literature there has been discussion on the question whether the acceptance of the terms and conditions of conventional bonds results in the conclusion of one agreement between the issuer and the bond holders or in several agreements between the issuer and each bond holder. For an overview of these discussions, *see* Prinsen 2004, pp. 13-24. Furthermore, in the Dutch literature there has been discussion on whether the terms and conditions of securities qualify as general conditions within the meaning of Art. 6:231 (a) DCC. For an overview of these discussions, *see* Uniken Venema & Eisma 1990, p. 81; Asser/Maeijer, Van Solinge & Nieuwe Weme 2010 (2-II*), no. 661; Prinsen 2004, pp. 24-25; Van der Velden 2008, pp. 269-275. Both discussions are not relevant for the focus of this subsection: the economic ownership of *sukuk* holders under Dutch property law.

547 Dutch Supreme Court 5 March 2004, *NJ* 2004, 316, with case note by Stein, para. 3.3.1. *Cf.* Dutch Supreme Court 3 November 2006, *NJ* 2007, 155, with case note by Van Schilfgaarde, para. 3.4.

548 Parliamentary History, Book 5 DCC 1981, p. 17. *Cf.* Dutch Supreme Court 23 September 2002, *NJ* 2003, 400, with case note by Kleijn, para. 3.5.2.

549 Dutch Supreme Court 5 March 2004, *NJ* 2004, 316, with case note by Stein, para. 3.3.1.

550 Dutch Supreme Court 3 November 2006, *NJ* 2007, 155, with case note by Van Schilfgaarde, para. 3.5.

551 *See* Asser/Mijnssen, De Haan & Van Dam 2006 (3-I), no. 483.

ownership should be codified in law.[552] The Dutch legislature did not codify economic ownership because there was no need to provide statutory rules for the legal position of an economic owner; his legal position could be determined by the rules of the contract pursuant to which his economic ownership was created.[553] In addition, the Dutch legislature mentioned that economic ownership should not be codified because it relates to fiduciary ownership and the English law trust, which are prohibited by article 3:84 (3) DCC.[554]

In the parliamentary history of article 3:84 (3) DCC some examples are given of transactions that are not invalidated by article 3:84 (3) DCC, such as: (i) the transfer of a property to a foundation or a BV with restricted objects that then becomes the owner of the property and that has a contractual relationship with other parties in relation to that property; or (ii) the issuance of depositary receipts for shares or immovable property possibly secured with security rights.[555] The proposed structure for *sukuk* transactions in this book is completely in line with such examples: the ownership of the property is separated from the patrimony of the originator and is transferred to the SPV (*i.e.* a BV or a foundation with restricted objects) that, in turn, holds the property for the *sukuk* holders according to the contractual arrangements between them.

The economic ownership of the *sukuk* holders has no effect towards third parties such as the creditors of the SPV. In a *sukuk* transaction the SPV has the right of ownership of the underlying property of the *sukuk* transaction and the *sukuk* holders have only contractual rights. Consequently, the creditors of the SPV can have recourse against the underlying property of a *sukuk* transaction because the property remains part of the patrimony of the SPV. In *Amsem/Van Tuijn & Leutscher,* the Dutch Supreme Court ruled that the transfer of economic ownership does not change the legal ownership positions of the parties.[556] The property remains available for attachment (*beslag*) by creditors of the legal owner.[557]

Furthermore, in the event of bankruptcy of the SPV, the property falls into its bankruptcy estate. In *Van den Bos q.q./Mulders & Welleman,* also known as *Nebula,* the Dutch Supreme Court had to deal with the question whether the economic owner of an immovable property could rent the immovable property

552 Parliamentary History, Book 5 DCC 1981, pp. 17-18.
553 *Ibid.*, p. 17.
554 *Ibid.*, p. 18.
555 Parliamentary History, Act Implementing Books 3, 5 and 6 DCC 1990, pp. 1201-1202.
556 Dutch Supreme Court 18 February 2000, *NJ* 2000, 278, paras. 4 and 2.7 of conclusion of Advocate-General.
557 *Ibid.*

after the bankruptcy of its legal owner to a third party with effect towards the bankruptcy estate.[558] The Dutch Supreme Court ruled that the bankruptcy of a party does not affect its agreements with other parties, but this does not mean that those other parties can exercise the rights under such agreements as if there were no bankruptcy, even if no active performance from the bankruptcy trustee is required and he only has to tolerate something.[559] As a result of the bankruptcy of the legal owner of the property, its economic owner can no longer enforce his right of use of the property against the bankruptcy trustee and, consequently, the economic owner cannot provide third parties, by concluding a rental agreement with them, a right of tenancy of the property that can be enforced towards the bankruptcy trustee of the legal owner either.[560] In a *sukuk* transaction, the bankruptcy trustee of the SPV in the case of its bankruptcy may default under the agreement with the *sukuk* holders. In such event, the *sukuk* holders have a contractual claim for damages as a result of breach of contract. Such contractual claims are ordinary, unsecured claims on the bankruptcy estate of the SPV.[561]

6.2.2.2 Security Rights for Sukuk *Holders through Collective Security Arrangement under Dutch Property Law*

Notwithstanding that the SPV is incorporated as a bankruptcy-remote vehicle, the *sukuk* holders may require security rights in order to secure their position in relation to other creditors of the SPV or in its bankruptcy under Dutch law. What is rather peculiar about the security rights of the *sukuk* holders is that the security rights are for a changing group of creditors: in the *sukuk al-musharaka* and the *sukuk al-ijarah* the *sukuk* holders can sell and transfer their *sukuk* in capital markets and (new) *sukuk* holders can enter and exit the pool of creditors. Such security arrangement is also referred to as a collective security arrangement.[562] In this subsection I assess the possibilities for a collective security arrangement for *sukuk* holders under Dutch law.

A collective security arrangement ensures that the security rights of the *sukuk* holders are administrated effectively and that possible enforcement is realised efficiently.[563] In collective security arrangements one party (the security agent) will acquire, administrate and, if need be, enforce the security

558 Dutch Supreme Court 3 November 2006, *NJ* 2007, 155, with case note by Van Schilfgaarde, para. 3.4. For more on the *Nebula* case, *see* Wibier 2008b, pp. 445-452.

559 According to the Dutch Supreme Court, the equality of creditors (*paritas creditorum*) as codified in Arts. 26 and 108 *ff.* DBA is otherwise violated, *see* Dutch Supreme Court 3 November 2006, *NJ* 2007, 155, with case note by Van Schilfgaarde, paras. 3.4-3.5.

560 *Ibid.*, para. 3.6.

561 Art. 37a DBA.

562 *See* Thiele 2003.

563 Thiele 2001, pp. 456-463.

rights for the group of creditors. In *sukuk* transactions the security agent can be a newly incorporated bankruptcy-remote SPV (the second SPV next to the (first) SPV that issues the *sukuk*). From a practical perspective, the structure and documentation of the collective security arrangement should be such that (new) creditors can enter and exit the pool of creditors without affecting the legal validity of the collective security arrangement.

In the Dutch literature there is debate about the form and the legal validity of collective security arrangements.[564] A collective security arrangement can be structured through agency (*vertegenwoordiging*) under Dutch law. The *sukuk* holders can jointly hold the security rights and create a community (*gemeenschap*) within the meaning of Chapter 7 book 3 DCC. Article 3:168 DCC provides the *sukuk* holders the possibility to agree on an administration scheme, pursuant to which they can appoint a security agent. However, creating a community leads to legal uncertainty with regard to: (i) whether Article 3:170 (3) DCC requires all *sukuk* holders to agree on the enforcement of the security right; (ii) whether the *sukuk* holders as the security rights holders should be identified, which might not be feasible on a practical level as the pool of *sukuk* holders keeps changing due to the trade of the *sukuk* in capital markets; and (iii) whether the security rights transfer by law to new *sukuk* holders, who purchase *sukuk* from existing *sukuk* holders.[565] As a result of the addressed legal uncertainty, collective security arrangements based on agency are rarely used in conventional finance transactions in the Dutch finance practice.[566]

A collective security arrangement can also be structured by using a fiduciary as security agent under Dutch law. The fiduciary is a security agent that holds the security rights in its own name. The *sukuk* holders do not acquire a joint security right. Instead, the SPV grants security directly to the security agent. The security agent administrates and, if need be, enforces the security rights for the *sukuk* holders based on an agreement between the security agent and the *sukuk* holders. The drawbacks discussed above with regard to a collective security arrangement based on agency do not occur when the security agent accepts the security rights in its own name. However, there is legal uncertainty in relation to the question whether a party that does not hold the secured claims can act as the security rights holder under Dutch law.

> The group of creditors (*sukuk* holders) are the parties that hold the secured claims, while the security agent is the security rights holder. In the literature two possible

564 *See* Kortmann, Rongen & Verhagen 2001a, pp. 818-823; Kortmann, Rongen & Verhagen 2001b, pp. 840-846; Thiele 2003; Thiele (*Zekerhedenrecht in ontwikkeling*) 2009; Wibier 2009b, pp. 629-632; Wibier 2010, pp. 84-86.

565 Thiele 2003, pp. 60-83; Thiele (*Zekerhedenrecht in ontwikkeling*) 2009, pp. 75-85.

566 Thiele 2003, p. 106.

impediments have been addressed in this regard.[567] First, the Dutch Civil Code seems to assume that the secured claims and the security rights are held by the same party.[568] Second, the dependent (*afhankelijk*) character of security rights (according to which security rights should follow rights to which they are connected) has been addressed as possibly problematic.[569]

A parallel debt clause (*parallelle vordering*) is used in Dutch finance practice to provide the security agent with a claim in its own name against the debtor and this parallel debt is subsequently secured.[570] Pursuant to a parallel debt clause, the security agent acquires a substantive and independent claim on the SPV that is equal to the entire amount of all payments outstanding for the *sukuk*. The claim of the security agent is parallel to the claims of the *sukuk* holders, that is, the claim of the security agent is connected to the claims of the *sukuk* holders such that each increase or decrease in the claims of the *sukuk* holders results in an equal increase or decrease in the claim of the security agent. The security agent has its own claim on the SPV and acquires security rights to secure that (parallel) claim. At the same time, the SPV is released from its obligation to pay the security agent after payment to the *sukuk* holders since each payment to the *sukuk* holders equally decreases the claim of the security agent.

In the literature other legal constructions besides the parallel debt clause have been discussed in relation to collective security arrangements. The security agent can also acquire a claim in its own name on the debtor through (i) a joint and several creditorship clause (*actieve hoofdelijkheid*) or (ii) a guarantee arrangement (*borgtocht-constructie*).[571]

The SPV/issuer can create security rights for the SPV/security agent to secure the parallel debt claim of the SPV/security agent against the SPV/issuer. The security rights are created over the underlying properties of the *sukuk* transactions: shares in a BV (in the *sukuk al-musharaka*), claims for instalment

567 Thiele 2001, pp. 456-463.
568 For example, *see* Art. 3:248 DCC.
569 *See* Art. 3:82 DCC.
570 There has been debate in the literature on the legal validity of a parallel debt clause. The prevailing view is that the use of a parallel debt clause is valid under Dutch law. *See* Kortmann, Rongen & Verhagen 2001a, pp. 818-823; Kortmann, Rongen & Verhagen 2001b, pp. 840-846; Thiele 2001, pp. 462-463; Thiele 2003, pp. 95-98; Thiele (*Zekerhedenrecht in ontwikkeling*) 2009, pp. 93-95; Polak & Van Mierlo 1997, pp. 26-27. Also *cf.* Wibier 2009b, pp. 629-632; Wibier 2010, pp. 84-86; Wibier 2011, pp. 39-40. For a dissenting view, *see* Van Achterberg & Brakel 1998, pp. 68-74.
571 For more on a joint and several creditorship clause and on a guarantee arrangement in relation to collective security arrangements, *see* Kortmann, Rongen & Verhagen 2001a, pp. 813-823; Thiele 2003, pp. 92-102.

payments of a purchase price (in the *sukuk al-murabaha*) or tangible properties (in the *sukuk al-ijarah*). The secured claim of the security agent is a claim 'parallel' to that of the *sukuk* holders. A default on the payments to the *sukuk* holders will, thus, also constitute a default on the payment to the security agent, resulting in the claims becoming due and payable simultaneously. In such event, the security agent can enforce its security rights. With regard to the *sukuk al-musharaka*, the security agent is bound by the transfer restrictions (*blokkeringsregeling*) in the articles of association of the *musharaka* BV as discussed in Chapter 5.[572] The security agent cannot sell and transfer the shares when the value of the tangible properties and the services of the *musharaka* BV is less than 30% of its total assets value based on its annual accounts of that year.[573] The security agent may, however, request a court to declare the transfer restrictions partially or completely non-applicable according to Article 2:195 (7) DCC.[574]

> The security agent holds, administrates and enforces the security rights under title of trust (*ten titel van beheer*) for the *sukuk* holders.[575] Nonetheless, no problems will arise with the *fiducia* prohibition of article 3:84 (3) DCC.[576] The prohibition of the *fiducia cum amico* in article 3:84 (3) DCC aims to avoid the creation of proprietary rights in a way not provided by the law, which otherwise would be in conflict with the closed legal system of Dutch property law.[577] However, the legal relationship between the security agent and the *sukuk* holders is solely contractual.

The *sukuk* holders are not protected against a possible bankruptcy of the security agent, however. The (parallel) claim of the security agent and the security rights held by the security agent fall into the bankruptcy estate of the security agent in case of its bankruptcy. Although its bankruptcy trustee has contractual obligations towards the *sukuk* holders, he may default on these obligations. In such event, the *sukuk* holders have an ordinary, unsecured claim for payment of damages against the bankruptcy estate of the security agent.[578] The incorporation of a security agent into a *sukuk* structure mitigates the bankruptcy risk of the SPV that issues the *sukuk*, but this bankruptcy risk as such is not eliminated completely. It is instead transferred to the SPV that

572 *See* Section 5.1 of Chapter 5.
573 *See* Section 5.1.2 of Chapter 5.
574 For a discussion of the impact of a partial or complete non-applicability of the transfer restrictions on the *Shari'ah* compliance of the *sukuk al-musharaka* transaction, *see* Section 5.1.3 of Chapter 5.
575 Kortmann, Rongen & Verhagen 2001b, p. 840.
576 *Ibid.*, pp. 844-845.
577 Dutch Supreme Court 19 May 1995, *NJ* 1996, 119, with case note by Kleijn/*AA* 1995, 11, with case note by Vriesendorp, para. 3.6.
578 *See* Art. 37a DBA.

is the security agent. The bankruptcy risk of the security agent cannot be eliminated completely under Dutch law. The bankruptcy risk is transferred from one bankruptcy-remote SPV (the issuer) to another bankruptcy-remote SPV (the security agent).

One could question the utility of collective security arrangements in *sukuk* transactions for the following four reasons. First, the bankruptcy of the SPV that is the issuer of the *sukuk* is unlikely. The SPV is a bankruptcy-remote vehicle. The managing board of the SPV will not act against the restrictions in the objects in the articles of association of the SPV due to a significant risk of directors' liability. Second, if the SPV goes bankrupt due to transgression of its objects by its managing board, its managing board is liable, which means that the *sukuk* holders have recourse against them.[579] Third, if the SPV goes bankrupt due to errors in its structuring (*e.g.* unforeseen tax costs, miscalculations in payment schedules, etc.), the only substantive creditors of the SPV will be the *sukuk* holders. Fourth, the bankruptcy risks of the issuer mentioned above cannot be eliminated with the use of a collective security arrangement because the security agent is exposed to similar risks.

In practice, nonetheless, collective security arrangements will most probably be used in *sukuk* transactions in the Netherlands. The risk of bankruptcy of the security agent may not be eliminated completely. Such risk is, however, rather theoretical because it is only relevant if the security agent – which is already a bankruptcy-remote SPV – goes bankrupt at a point when the issuer – which is also a bankruptcy-remote SPV – also defaults on its payments.[580] From a structural perspective, the use of collective security arrangements further mitigates the overall bankruptcy risks to which the *sukuk* holders are exposed in *sukuk* transactions. Often, major financial interests are at stake. Each minor mitigation of the bankruptcy risks in such transactions justifies additional structural mechanisms. Figures 4, 5 and 6 provide an overview of each of the discussed *sukuk* structures with a collective security arrangement.

579 *Cf.* Dutch Supreme Court 20 June 2008, *NJ* 2009, 21, with case note by Maeijer & Snijders; *cf.* Dutch Supreme Court 29 November 2002, *NJ* 2003, 455, with case note by Maeijer.

580 It has, however, been argued that in times of financial crises this view might be too optimistic, *see* Thiele (*Zekerhedenrecht in ontwikkeling*) 2009, p. 101. In the literature, legislative amendments have been proposed, pursuant to which the proceeds collected by the security rights holder should be deposited in a designated account to which the creditors of the security agent have no recourse, *see* Thiele 2003, pp. 261-263.

Figure 4 ***Sukuk al-musharaka*** **with collective security arrangement under Dutch law**

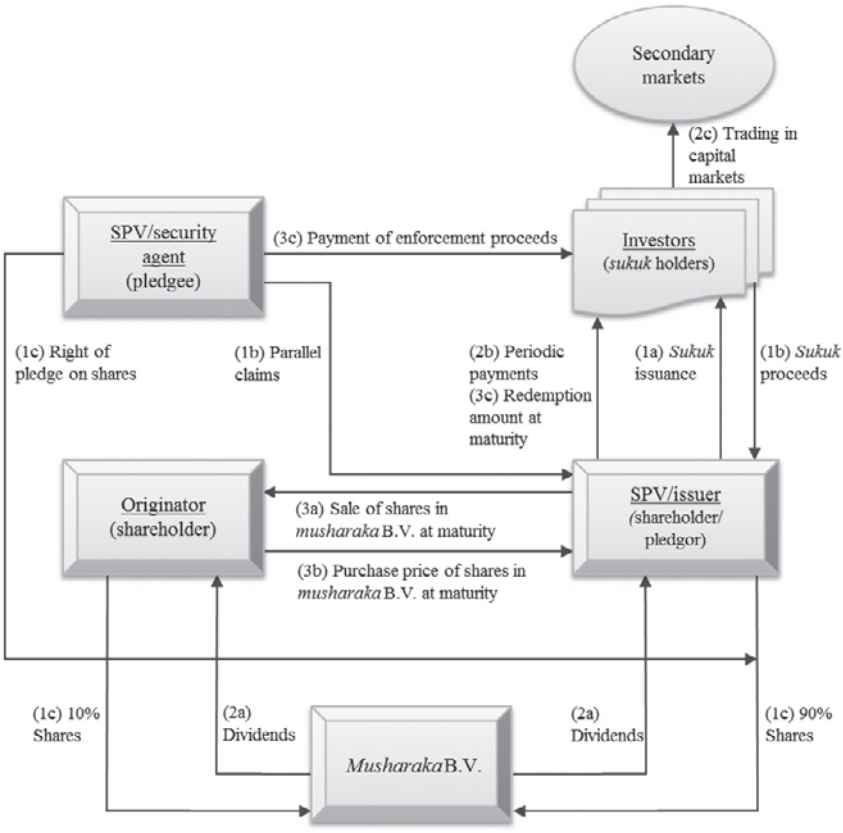


Figure 5 ***Sukuk al-murabaha*** **with collective security arrangement under Dutch law**

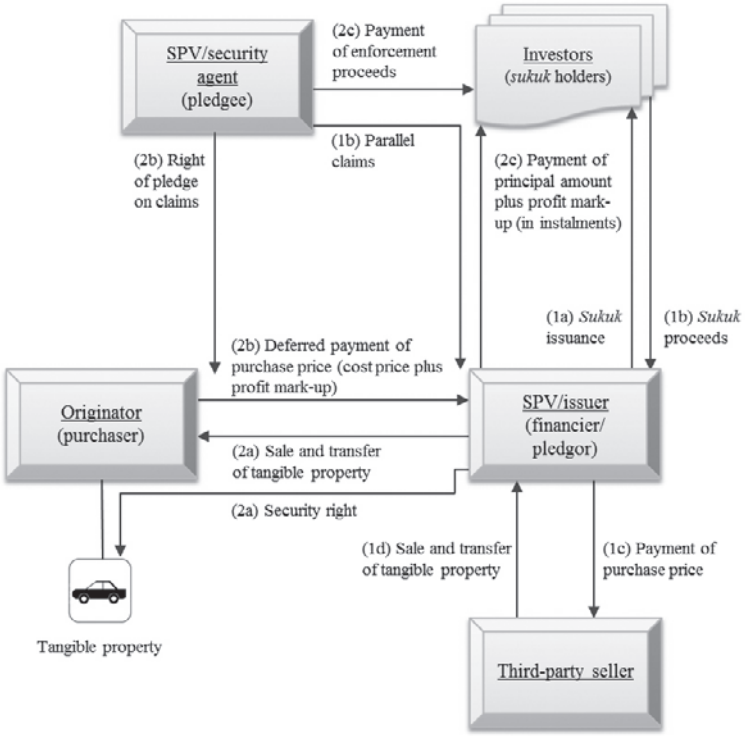
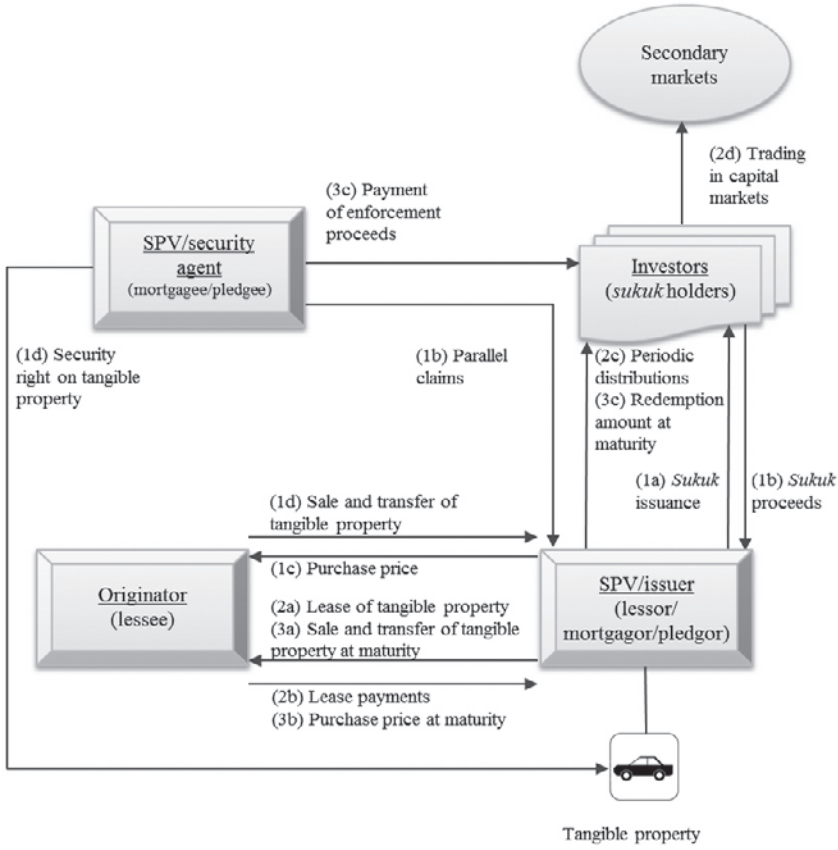


Figure 6 ***Sukuk al-ijarah*** **with collective security arrangement under Dutch law**



6.2.2.3 *Statutory Joint Right of Pledge of* Sukuk *Holders in* Sukuk al-Musharaka *through Issuance of Depositary Receipts for Shares under Dutch Property and Corporate Law*

The legal structure of *sukuk* transactions under Dutch law as discussed in the previous subsections resembles the Dutch legal concept of depositary receipt for properties (*certificering van goederen*). The issuance of depositary receipts for properties refers to a process where an administration office[581] (*stichting administratiekantoor*) issues depositary receipts for properties entrusted to its management. The administration office has the right of ownership of

581 The administration office is often referred to as a trust office. In this research I use the term 'administration office' in order to avoid confusion with an English law trust. An administration office is not an English law trust, but a Dutch foundation that is incorporated for the purpose of holding properties entrusted to its management for depositary receipt holders to whom it has issued depositary receipts.

the properties. Pursuant to the administration conditions (*administratievoorwaarden*), the depositary receipt holders are entitled to the financial benefits of the properties.[582] As a result, the right of ownership of the properties is separated from their economic benefits.[583] A possible qualification of *sukuk* transactions as depositary receipts for properties is relevant in light of Article 3:259 DCC, which provides depositary receipt holders a statutory joint right of pledge (*wettelijk gezamenlijk pandrecht*). The statutory joint right of pledge can serve as an alternative to a collective security arrangement. The statutory joint right of pledge has the benefit that it has a statutory basis in Article 3:259 DCC, which provides rules for the creation and enforcement of the joint right of pledge, leaving no room for legal uncertainty with regard to its legal validity. In addition, the *sukuk* holders as depositary receipts holders will have a proprietary relationship with the issuer (the administration office) of the *sukuk* (the depositary receipts) in such case and are secured creditors in case of its bankruptcy, contrary to the structures described in Sections 6.2.2.1 and 6.2.2.2 where the *sukuk* holders only have a contractual relationship with the SPV/issuer or with the SPV/security agent and are ordinary, unsecured creditors in their respective bankruptcies.

> The administration office acquires the ownership of the properties under title of trust. With regard to depositary receipts for shares, the phrase 'under title of trust' is mentioned in articles 2:336 (2) and 2:341 (6) DCC. The transfer of the properties to an administration office is, however, not in conflict with article 3:84 (3) DCC. According to the Dutch Supreme Court, a transaction where one party has the complete right of ownership of a property, while another party has contractual rights only is not in conflict with the closed legal system of Dutch property law.[584] That is the case with depositary receipts for properties: the administration office is the sole owner of the properties and the properties are part of its patrimony (and

582 In the literature there is discussion on the legal character of the administration conditions. One of the questions is whether the administration conditions qualify as general conditions within the meaning of Art. 6:231 (1) (a) DCC, *see* Van den Ingh 1991, pp. 154-156; Uniken Venema & Eisma 1990, p. 82; Asser/Maeijer, Van Solinge & Nieuwe Weme 2010 (2-II*), no. 664. Another question with regard to the legal character of the administration conditions is whether the administration conditions qualify as a contract of instruction (*opdracht*) within the meaning of Art. 7:400 *ff.* DCC (and more in particular, one of its species: a contract of mandate (*lastgeving*) according to Art. 7:414 DCC), *see* Uniken Venema & Eisma 1990, pp. 81-82; Asser/Maeijer, Van Solinge & Nieuwe Weme 2010 (2-II*), no. 661. However, both discussions are not relevant for the focus of this subsection: the security rights of the *sukuk* holders under Dutch property law.

583 In the case of issuing depositary receipts for shares in a stock company, it leads to a division of the controlling rights of the shares from their financial rights, *see* Asser/Maeijer, Van Solinge & Nieuwe Weme 2010 (2-II*), no. 658.

584 *See* Dutch Supreme Court 19 May 1995, *NJ* 1996, 119, with case note by Kleijn/*AA* 1995, 11, with case note by Vriesendorp, para. 3.6.

bankruptcy estate in the case of its bankruptcy). The depositary receipt holders have only contractual claims as stipulated in the administration conditions.

The issuance of depositary receipts for properties does not have a statutory basis under Dutch law. The most well-known form of issuing depositary receipts for properties is the issuance of depositary receipts for shares. Books 2 and 3 DCC contain several references to the issuance of depositary receipts for shares, but they do not provide a statutory definition of it.[585] The Dutch legislature found it impossible to provide an appropriate statutory definition of the issuance of depositary receipts for shares because the substance of this legal construction can vary endlessly.[586] The Dutch Supreme Court acknowledged the issuance of depositary receipts for shares in *Drukker/Drukker*, where it confirmed that as a starting point the issuance of depositary receipts for shares in a BV where the depositary receipts will be non-exchangeable is not socially unacceptable.[587]

As addressed, Article 3:259 DCC provides depositary receipt holders a statutory joint right of pledge. It is applicable to depositary receipts for shares and to depositary receipts for debt claims. Article 3:259 (1) DCC describes the depositary receipts issuing process as a process where the owner (the administration office) of shares or debt claims issues depositary receipts to third parties (the depositary receipt holders). According to Article 3:259 (1) DCC, the depositary receipt holders have a claim on the issuer of the depositary receipts for payment of the amount promised to them. There should be a connection between the depositary receipts and the underlying shares or debt claims.[588] This connection is created with the administration conditions. Pursuant to the administration conditions, the depositary receipt holders are entitled to the proceeds of the shares (*i.e.* dividends) or the debt claims (*i.e.* interests). The Dutch legislature decided to provide the depositary receipt holders a statutory joint right of pledge on the underlying shares or debt claims to secure

585 Art. 3:259 DCC on the statutory joint right of pledge of the depositary receipt holders is a provision of book 3 DCC that mentions the issuance of depositary receipts for shares and debt claims. Some references in book 2 DCC can be found in Arts. 2:24, 2:202, 2:204a, 2:208, 2:212, 2:220, 2:223, 2:224, 2:227, 2:230, 2:233, 2:329, 2:334dd, 2:336, 2:346 DCC for the BV and the corresponding articles for the NV in book 2 DCC.

586 Van den Ingh 1991, pp. 15-18.

587 Dutch Supreme Court 1 July 1988, *NJ* 1989, 226, with case note by Maeijer, para. 3.7. *A fortiori*, the issuance of depositary receipts for shares where the depositary receipts are exchangeable *see*ms to be legally acknowledged as well, *see* Asser/Maeijer, Van Solinge & Nieuwe Weme 2010 (2-II*), no. 658. Although the issuance of depositary receipts for shares is the only form of issuance of depositary receipts that has a legal basis (in case law of the Dutch Supreme Court), the issuance of depositary receipts for (other) properties is also broadly accepted in the literature and legal practice, *see* Van der Grinten & Treurniet 1964, pp. 7-8; Uniken Venema & Eisma 1990, pp. 50-53; Van den Ingh 1991, pp. 15-18.

588 *Cf.* Stein (GS Vermogensrecht, Art. 3:259 DCC) 2013, no. 16.

their position, against a possible bankruptcy of the administration office in particular.[589]

The underlying properties in the *sukuk* structures discussed in this book are shares in a BV (*sukuk al-musharaka*), claims for instalment payments of a purchase price (*sukuk al-murabaha*) or tangible properties (*sukuk al-ijarah*). Article 3:259 DCC is applicable to the *sukuk al-musharaka* if it is structured through the issuance of depositary receipts for shares in the *musharaka* BV. However, the underlying properties in the *sukuk al-murabaha* and the *sukuk al-ijarah* do not fall within the scope of the depositary receipts for properties that are encumbered with the joint right of pledge of Article 3:259 DCC. Article 3:259 DCC is not applicable to the issuance of depositary receipts for a tangible property, which is the underlying property in the *sukuk al-ijarah*. Furthermore, the claims for instalment payments of the purchase price of a tangible property sold by the SPV to the originator in the *sukuk al-murabaha* do not fall within the scope of 'debt claims' of Article 3:259 DCC. The article is codified for financial transactions and debt claims refer to debt claims from securities such as bond loans.[590] Therefore, the issuance of depositary receipts for properties will be discussed only in relation to the *sukuk al-musharaka*.

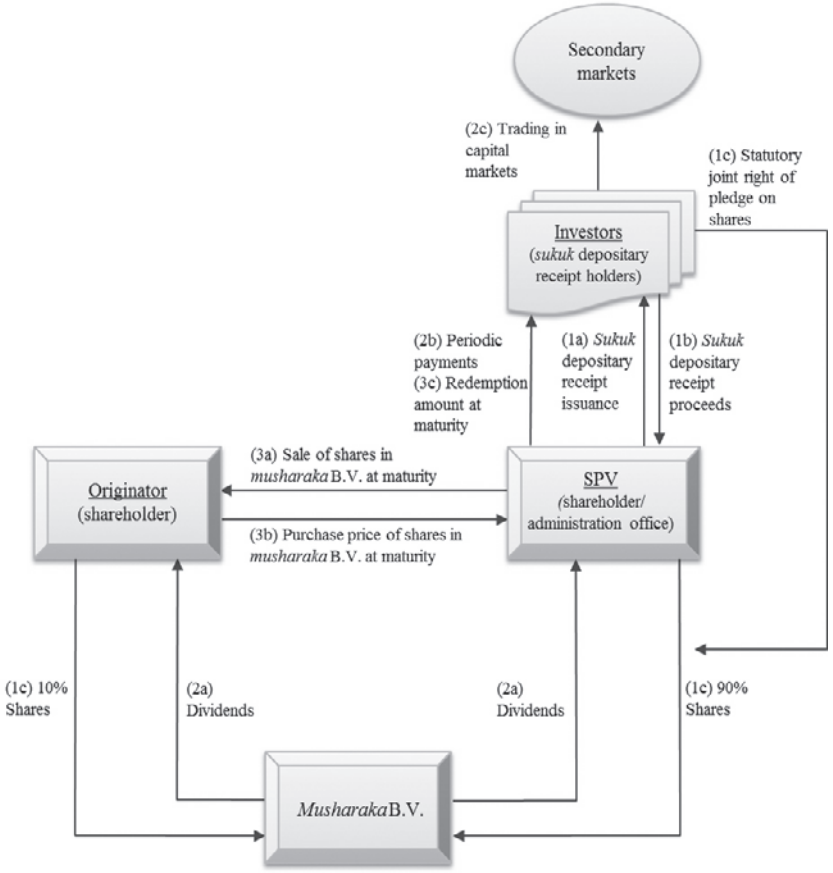
> One could argue that a court may apply article 3:259 DCC by way of analogy in case of the *sukuk al-ijarah* and the *sukuk al-murabaha*, due to their similarities with the *sukuk al-musharaka*. Furthermore, article 3:259 DCC has been codified to facilitate financial transactions in financial markets. The *sukuk* transactions discussed in this book are financial transactions. However, such application by a court remains highly uncertain. There is no indication in the Dutch Civil Code or any case law for such application of article 3:259 DCC by way of analogy.

In the *sukuk al-musharaka* the originator and the SPV (the administration office) hold the shares in the *musharaka* BV. The administration office issues *sukuk* (the depositary receipts) for the shares in the *musharaka* BV entrusted to its management, pursuant to the administration conditions of the depositary receipts. Figure 7 gives an overview of the *sukuk al-musharaka* structured through the issuance of depositary receipts for shares in the *musharaka* BV under Dutch law.

589 Parliamentary History, Book 3 DCC 1981, pp. 567-568.

590 Art. 3:259 (2) DCC explicitly refers to the 'issuer' of debt claims, which indicates that securities should be issued.

Figure 7 ***Sukuk al-musharaka*** **through issuance of depositary receipts for shares under Dutch law**



In the *sukuk al-musharaka*, the *sukuk* holders are the depositary receipt holders who could acquire a statutory joint right of pledge. The joint right of pledge of the *sukuk* holders is created by operation of law, if the *sukuk* holders have rights to attend meetings (*vergaderrechten*) pursuant to the articles of association of the *musharaka* BV.[591] As a result, the administration office acquires the shares of the *musharaka* BV encumbered with the statutory joint right of pledge of the *sukuk* holders from the outset. The incorporation of a security agent is not required for the administration and enforcement of the joint right of pledge of the *sukuk* holders, decreasing structuring and transaction costs compared to

591 Art. 3:259 (2) DCC.

a collective security arrangement. As a result, contrary to a collective security arrangement where the *sukuk* holders remain exposed to a bankruptcy risk which is transferred from the issuer to the security agent, the *sukuk* holders as depositary receipt holders are not exposed to such bankruptcy risk. The depositary receipt holders hold the joint right of pledge in community (*gemeenschap*) within the meaning of Chapter 7 book 3 DCC.[592] However, the legal uncertainties addressed with regard to a collective security arrangement on the basis of agency do not occur because Article 3:259 DCC provides a special legal regime for the joint right of pledge of the depositary receipt holders.

> The depositary receipt holders that have rights to attend meetings have the right to attend general meetings of shareholders, in person or by proxy, and to speak at the general meetings of shareholders.[593] This also provides the statutory basis for the corporate law rights of the depositary receipt holders: depositary receipts with rights to attend meetings provide depositary receipt holders with additional controlling rights in the BV. Some important controlling rights that the depositary receipt holders with rights to attend meetings have are: the right to inspect and to receive a copy of the annual reports and accounts,[594] the right to convene a general meeting of shareholders,[595] the right to be called for a general meeting of shareholders,[596] the right to present agenda items for a general meeting of shareholders[597] and the right to inspect minutes drafted by the managing board of resolutions taken at a general meeting of shareholders.[598] The originator should be aware that the *sukuk* holders could exert influence at a general meeting of shareholders of the *musharaka* BV, which could be drawback compared to a collective security arrangement.

Article 3:259 (3) DCC provides a special enforcement procedure for the enforcement of the statutory joint right of pledge of depositary receipt holders. The parliamentary history clarifies that the most important reason for separate rules for the enforcement of the joint right of pledge was to avoid that one depositary receipt holder could enforce the joint right of pledge to fulfil payment to himself at the cost of other depositary receipt holders.[599] In the event of default in payment of what is due to the *sukuk* holders as the depositary receipt

592 Parliamentary History, Book 3 DCC 1981, p. 568.
593 *See* Art. 2:227 DCC.
594 Art. 2:212 DCC.
595 Art. 2:220 (2) DCC.
596 Art. 2:223 DCC.
597 Art. 2:224a (2) DCC.
598 Art. 2:230 (4) DCC. For a complete overview of the controlling rights of depositary receipt holders with rights to attend meetings, *see* Van den Ingh 1991, pp. 245-262; Van den Ingh 2003, pp. 2-6.
599 *See* Parliamentary History, Book 3 DCC 1981, p. 571.

holders, each *sukuk* holder has the right to have the shares in the *musharaka* BV sold, in whole or in part, and to be paid by preference from the proceeds of the sale. The *sukuk* holder who wishes to enforce the joint right of pledge files a request for the appointment of an administrator (*bewindvoerder*) with the interlocutory judge of the district court of the domicile of the administration office. This results in loss of control. Unlike a collective security arrangement, where the parties to the *sukuk* transaction contractually agree on the enforcement options of the security agent and on the rights of the *sukuk* holders to require the security agent to enforce the security rights, Article 3:259 (3) DCC provides each *sukuk* holder the right to file a request for the appointment of an administrator who will enforce the joint right of pledge.

> The addressed risk of loss of control may be mitigated to some extent. Pursuant to the administration conditions, the *sukuk* holders can covenant that they will not file a request for the appointment of an administrator, except for in case of an event of default. It is, however, possible that a court deals with a request of a *sukuk* holder for the appointment of an administrator, notwithstanding that such request has been filed in breach of the administration conditions. The originator can also incorporate an SPV as a(n) (security) agent that will manage the rights of the *sukuk* holders (possibly together with other security rights over other assets than the shares in the *musharaka* BV). The (other) *sukuk* holders, the *musharaka* BV, or the originator can request the court to appoint the (security) agent as administrator at the hearing where the request of the *sukuk* holder who wishes to enforce the statutory joint right of pledge is dealt with. The court is, however, not obliged to respect such request for the appointment of the (security) agent as administrator and it can appoint the administrator at its complete discretion.

Once appointed, the administrator sells the shares and distributes the proceeds. The administrator should respect the general rules for enforcement of rights of pledges.[600] This means that he can sell the shares in a public auction[601] or outside a public auction with approval of an interlocutory judge.[602] If not all *sukuk* holders agree with the sale, only the part of the pledged shares corresponding to the right of the *sukuk* holders wishing to enforce the joint right of pledge is sold. The right of pledge of the *sukuk* holders who agree with the enforcement is extinguished by payment of the proceeds to them. The *sukuk* holders who do not consent with the enforcement will still hold a joint right of pledge on the shares of the *musharaka* BV remaining after the

600 Kelterman 2009, p. 176.
601 Art. 3:250 DCC.
602 Art. 3:251 DCC.

enforcement. Furthermore, upon request of one of the *sukuk* holders or *ex officio*, the interlocutory judge may order that measures be taken in the interest of *sukuk* holders who have not consented to the sale and the interlocutory judge may determine that the sale must be approved by him in order to be valid.[603]

Strictly speaking, the administrator is not the pledgee of the statutory joint right of pledge. The administrator is, nonetheless, acting for the *sukuk* holders who are the joint pledgees. Therefore, the administrator is bound by the transfer restrictions (*blokkeringsregeling*) in the articles of association of the *musharaka* BV as discussed in Chapter 5: the administrator cannot sell and transfer the shares when the value of the tangible properties and the services of the *musharaka* BV is less than 30% of its total assets value based on its annual accounts of that year.[604] The administrator may request a court to declare the transfer restrictions partially or completely non-applicable according to Article 2:195 (7) DCC.[605]

6.2.2.4 *Non-voting Shares for* Sukuk *Holders in* Sukuk al-Musharaka *under Dutch Corporate Law*

With regard to the *sukuk al-musharaka*, it is also possible to provide the *sukuk* holders the economic ownership of the underlying property of the *sukuk* transaction (shares in a *musharaka* BV) through the issuance of non-voting shares (*stemrechtloze aandelen*). With the entry into force of the Flex BV law, the issuance of non-voting shares in a BV is possible.[606] Both non-voting shares and depositary receipts for shares provide their holders financial rights without substantive controlling rights. Therefore, both legal concepts have been compared in the literature.[607] As an alternative to the issuance of depositary receipts for shares to *sukuk* holders through an administration office, the *musharaka* BV can directly issue non-voting shares to *sukuk* holders. An advantage of the issuance of non-voting shares compared to the issuance of depositary receipts for shares is that the incorporation of an administration office is not required. As a result, the *sukuk* holders as holders of non-voting shares are not exposed to a possible bankruptcy risk of the administration office (and there is no need for security rights either).[608]

Non-voting shares, however, provide their holders different controlling rights compared to depositary receipts for shares. One such difference is that

603 Art. 3:259 (3) DCC.
604 *See* Section 5.1.2 of Chapter 5.
605 For the impact of the partial or complete non-applicability of the transfer restrictions on the *Shari'ah* compliance of the *sukuk* transaction, *see* Section 5.1.3 of Chapter 5.
606 *See* Art. 2:228 (5) DCC.
607 *See* Portier (*Het nieuwe BV-recht voor de praktijk*) 2008, pp. 221-268; Van Olffen, De Kluiver & Legein 2013, pp. 77-97 & 123-131; Salah 2013b, pp. 47-51.
608 Salah 2013b, p. 49.

the holders of non-voting shares have no voting rights in the general meeting of shareholders of the BV, while the administration office has voting rights in the general meeting of shareholders, which it will exercise in favour of the depositary receipt holders.[609] In the *sukuk al-musharaka*, such voting rights have significant impact because they enable the administration office as SPV to ensure the *Shari'ah* compliance of the *musharaka* BV. As discussed in Chapter 5, the objects of the *musharaka* BV in its articles of association should stipulate that it is a *Shari'ah*-compliant entity and its articles of association should have transfer restrictions.[610] In addition, the articles of association of the *musharaka* BV should exclude the possibility to amend its objects and its transfer restrictions.[611] Nonetheless, its objects or transfer restrictions can be amended if all shareholders accept such amendment in a general meeting of shareholders where all subscribed capital is represented.[612] The holders of non-voting shares have no voting rights and cannot obstruct such amendment. In the case of depositary receipts for shares, however, the administration office has voting rights in the general meeting of shareholders and it can obstruct amendments of the articles of association of the *musharaka* BV that affect the *Shari'ah* compliance of the *musharaka* BV from being accepted. Hence, the choice between the issuance of depositary receipt for shares with meeting rights or non-voting shares mainly depends on the amount of control that the *sukuk* holders (through an administration office) should have in the *sukuk* transaction.

Concluding, the *sukuk* holders can acquire the economic ownership of the underlying properties in the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah* under Dutch law. Pursuant to the terms and conditions of the *sukuk*, the *sukuk* holders should be entitled to the financial benefits realised with the underlying property of the relevant *sukuk* transaction. The *sukuk* holders have only contractual claims on the SPV, which means that the SPV remains the owner of the underlying property and the underlying property falls into its patrimony (or bankruptcy estate in case of its bankruptcy). The contractual claims of the *sukuk* holders can be secured with a collective security arrangement: a security agent will hold security rights to secure a parallel claim (parallel to the claims of the *sukuk* holders), which it will administer and enforce for the *sukuk* holders. In case of the *sukuk al-musharaka*, the issuance to *sukuk* holders of depositary receipts with meeting rights is preferred from a property law perspective due to the statutory joint right of pledge of Article 3:259 DCC.

609 *Ibid.*, p. 50.
610 *See* Section 5.1.2 of Chapter 5.
611 *Ibid.*
612 *See* Art. 2:231 (1) DCC.

6.2.3 The Rights of *Sukuk* Holders in the Bankruptcy of the Originator in *Sukuk* Transactions under Dutch Bankruptcy Law

In this section I assess the legal position of the *sukuk* holders in the event of bankruptcy of the originator under Dutch law. According to the Islamic finance rules for *tawreeq,* an SPV should be incorporated and the right of ownership of the underlying property of the relevant *sukuk* transaction should be transferred from the originator to the SPV.[613] These two rules ensure that there is a separation of the underlying property from the patrimony of the originator. A bankruptcy is the ultimate test for the question whether property is separated from the patrimony of the originator. A bankruptcy also illustrates what rights the *sukuk* holders have in relation to the originator. Furthermore, the *sukuk* holders in *sukuk* transactions will be interested in their legal position in the event of bankruptcy of the originator since they have provided funding to it. There are no specific Islamic finance law requirements that need to be taken into consideration for *sukuk* structures in this regard. In this section I discuss the rights of the SPV and the *sukuk* holders in case of bankruptcy of the originator under Dutch law. This means that my focus will be on the legal relationship between the originator, the SPV and the *sukuk* holders as marked in Figures 8, 9 and 10. Bankruptcy considerations with regard to the SPV were discussed in the previous subsections.[614]

613 *See* the first and second Islamic finance rules for *tawreeq*, as mentioned in Section 6.1 of this chapter.

614 *See* Sections 6.2.1 and 6.2.2 of this chapter.

Figure 8 ***Sukuk al-musharaka*** **under Dutch bankruptcy law**

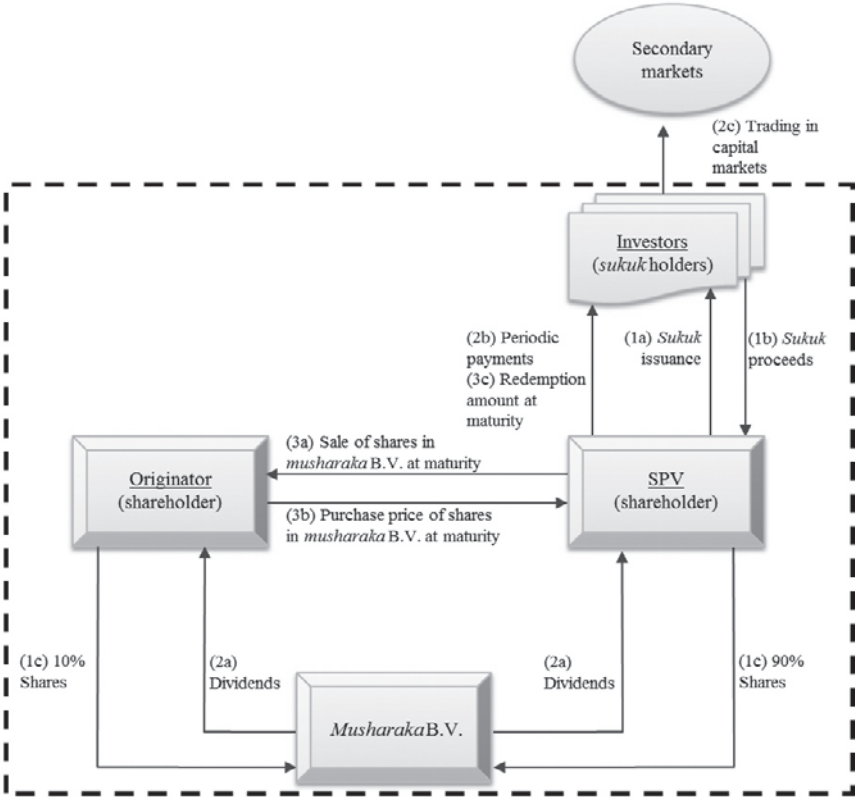


Figure 9 ***Sukuk al-murabaha*** **under Dutch bankruptcy law**

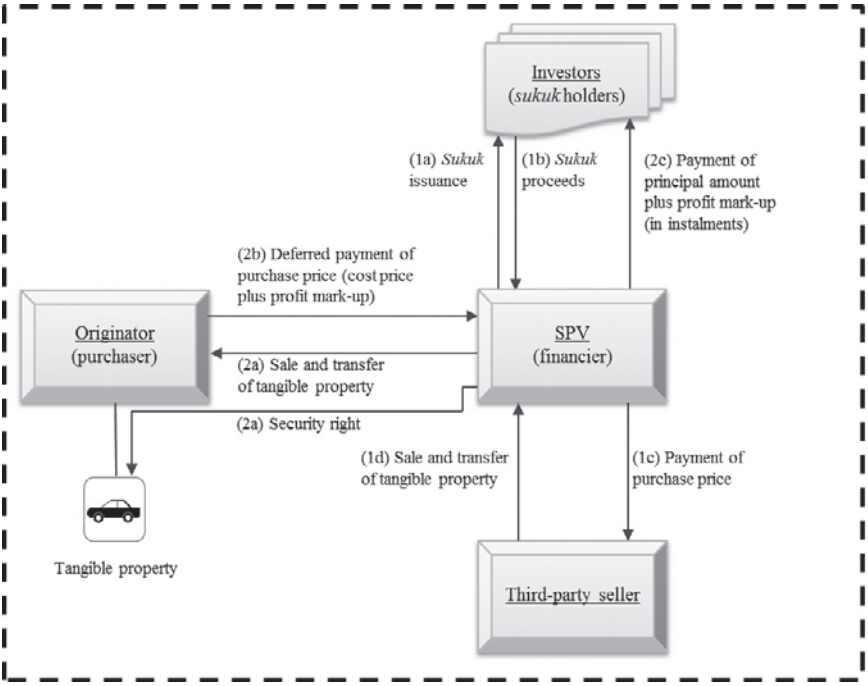
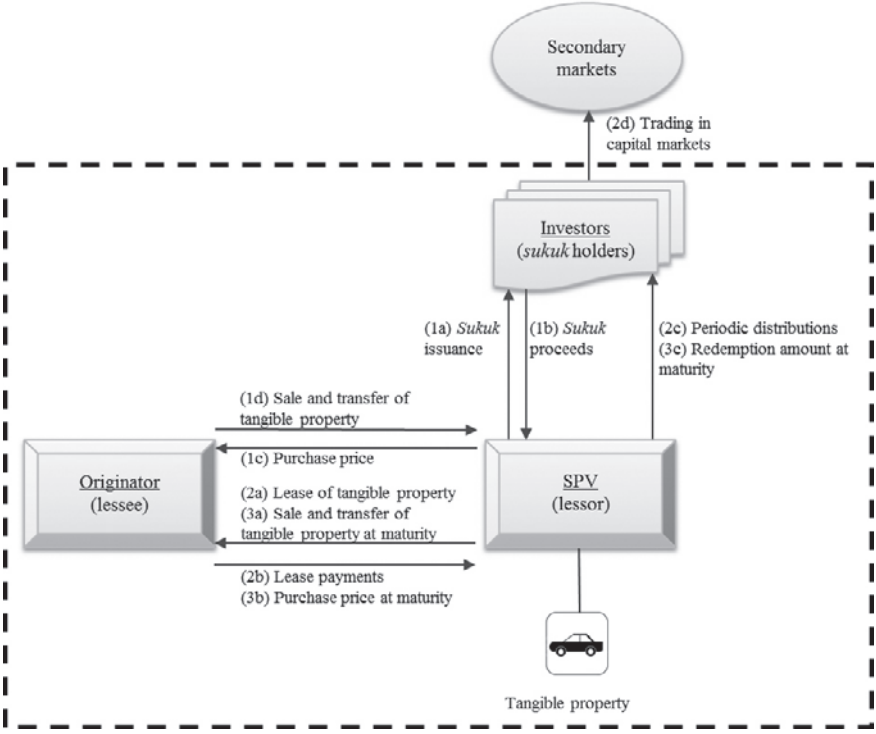


Figure 10 ***Sukuk al-ijarah*** **under Dutch bankruptcy law**



6.2.3.1 *The Rights of* Sukuk *Holders in the Bankruptcy of the Originator in the* Sukuk al-Musharaka *under Dutch Bankruptcy Law*

In the *sukuk al-musharaka* the originator and the SPV hold shares as shareholders of the *musharaka* BV.[615] As a starting point, the bankruptcy of the originator does not affect the position of the SPV or of the *musharaka* BV under Dutch law. The SPV holds shares in the *musharaka* BV and those shares fall into the patrimony of the SPV. The shares of the *musharaka* BV held by the originator fall into the bankruptcy estate of the originator.[616] Hence, the *musharaka* BV will have a bankrupt shareholder. The *musharaka* BV can, nonetheless, continue its business and possibly pay dividends to its shareholders and, subsequently, the SPV can continue making periodic payments to the *sukuk* holders.

615 *See* Section 5.1 of Chapter 5.
616 Art. 20 DBA.

The bankruptcy trustee of the originator may, however, sell and transfer the shares of the *musharaka* BV. The bankruptcy trustee is bound by the transfer restrictions of the *musharaka* BV in such case as described in Chapter 5: the bankruptcy trustee cannot sell and transfer the shares when the value of the tangible properties and the services of the *musharaka* BV is less than 30% of its total assets value based on its annual accounts of that year.[617] The bankruptcy trustee may request a court to declare the transfer restrictions partially or completely non-applicable.[618] If the court declares the transfer restrictions partially or completely non-applicable, the bankruptcy trustee can sell and transfer the shares disregarding the transfer restrictions. This may affect the *Shari'ah* compliance of the *sukuk al-musharaka* structure, not upfront, but once the court declares the transfer restrictions non-applicable. As mentioned in Chapter 5, the addressed risk is a litigation risk.[619] Such litigation risk will materialise in case of bankruptcy of the originator because the bankruptcy trustee of the originator will act in the interest of the bankruptcy estate and will not be interested in the Islamic law requirements of the *sukuk al-musharaka* transaction.

The bankruptcy of the originator can also trigger the bankruptcy of the *musharaka* BV: the *musharaka* BV may, for example, be dependent on supplies from the originator to continue its business. After liquidation of the originator, the supplies to the *musharaka* BV may end, which could result in the bankruptcy of the *musharaka* BV. In case of bankruptcy of the *musharaka* BV, the originator and the SPV as its shareholders are entitled to payments only if the creditors of the *musharaka* BV are paid and a surplus remains thereafter.[620] The ordinary, unsecured creditors of a BV have priority over its shareholders in the order of ranking of creditors under Dutch law. Most Dutch bankruptcies end with insufficient funds to pay ordinary, unsecured creditors (*opheffing wegens gebrek aan baten*).[621] Consequently, the *sukuk* holders will most probably lose their investments. In the event of bankruptcy of the *musharaka* BV it becomes more evident that the SPV as shareholder ranks low in the order of ranking of creditors and that the *sukuk* holders bear the economic risks thereof, stressing the equity feature of the *sukuk al-musharaka* transaction for the *sukuk* holders. This is, in turn, in line with the concept of profit-and-loss-sharing under Islamic finance law.

617 *See* Section 5.1.2 of Chapter 5.
618 Art. 2:195 (7) DCC. *See* Section 5.1.3 of Chapter 5.
619 *See* Section 5.1.3 of Chapter 5.
620 Art. 2:23b (1) DCC.
621 *See* Vriesendorp 2013, pp. 302-304. Art. 16 DBA provides the procedure for completion of liquidation where there are insufficient funds to pay ordinary, unsecured creditors.

6.2.3.2 *The Rights of* Sukuk *Holders in the Bankruptcy of the Originator in the* Sukuk al-Murabaha *under Dutch Bankruptcy Law*

In the event of bankruptcy of the originator in the *sukuk al-murabaha*, the SPV will have claims on the bankruptcy estate of the originator for payment of the outstanding instalments.[622] These claims are part of the patrimony of the SPV and do not fall into the bankruptcy estate of the originator. It is a right of the SPV to receive performance of an obligation from the originator, that is, payment of the instalments. In a bankruptcy scenario where a bankrupt debtor (originator) is not able to (fully) perform such obligation and its bankruptcy trustee may default on the performance of such obligation, leaving a creditor behind with an ordinary, unsecured claim for damages on the bankrupt estate,[623] the difference between a tangible property and an intangible property such as claims for payment of instalments is illustrated best.

> Remarkably, Islamic finance law does not allow the trade of the *sukuk al-murabaha* due to the lack of an underlying tangible property in the *sukuk* transaction. The scope of Islamic property law is restricted to tangible property (*ayn*).[624] Although the rationale for the impermissibility of the trade in the *sukuk al-murabaha* relates to the prohibition of *riba* under Islamic finance law, a bankruptcy scenario shows that the emphasis on tangible property is not illusive.

The claim of the SPV may, however, be secured with security rights on a tangible property in the *sukuk al-murabaha*. Under Dutch bankruptcy law the SPV can exercise its security rights as secured creditor (*separatist*) as if there were no bankruptcy.[625] In the event of default on instalments by the bankruptcy trustee of the originator, the SPV can enforce its security rights. The rights of the SPV are, however, restricted in two ways. First, the bankruptcy trustee of the originator can request the supervisory judge (*rechter-commissaris*) to order a stay, a cooling-off period (*afkoelingsperiode*), of two months with a possible extension of two months.[626] During this period of four months maximum the SPV cannot exercise its rights without consent of the supervisory judge. It cannot claim the encumbered tangible property if it is under the control of (*in de macht van*) the bankruptcy trustee of the originator and it can also not seek recourse against the encumbered tangible property. Second, the bankruptcy trustee of the originator can impose the SPV with a reasonable period (*redelijke termijn*) within which it has to exercise its security rights in order

622 *See* Section 5.2 of Chapter 5.
623 Art. 37a DBA.
624 *See* Section 2.3.1 of Chapter 2.
625 Art. 57 DBA.
626 Art. 63a DBA.

to liquidate the bankruptcy estate expeditiously.[627] The SPV may request the supervisory judge to extend such reasonable period.[628] If the SPV fails to sell the encumbered tangible property within the period provided by the bankruptcy trustee of the originator, the bankruptcy trustee may sell the tangible property himself and pay the proceeds to the SPV taking into account his rank, but after deduction of the bankruptcy costs (*faillissementskosten*), which can be substantial.[629]

6.2.3.3 The Rights of Sukuk *Holders in the Bankruptcy of the Originator in the* Sukuk al-Ijarah *under Dutch Bankruptcy Law*

In case of bankruptcy of the originator in the *sukuk al-ijarah* the tangible property that is the subject matter of the sale and leaseback does not fall into the bankruptcy estate of the originator. The SPV is the owner of the tangible property and the tangible property forms part of its patrimony. The SPV as the owner of the tangible property can sell and transfer it to a third party and use the proceeds to redeem the *sukuk*. The *ijarah* agreement qualifies as a rental agreement under Dutch law.[630] If the SPV sells and transfers the tangible property to a third party, that third party also acquires the rights and obligations of the SPV as lessor under the *ijarah* agreement.[631] A third party may, therefore, not be interested in the purchase of a tangible property with a rental agreement with a bankrupt lessee (originator).

Under Dutch bankruptcy law the SPV (lessor) and the bankruptcy trustee of the originator (lessee) both have the right to terminate (*opzeggen*) the *ijarah* agreement with a notice period of three months maximum.[632] The lease payments over the three months' notice period are estate claims (*boedelschulden*).[633] These claims must be paid before any payments can be made to ordinary, unsecured creditors in bankruptcy.[634] Due to the ranking of lease payments (over the maximum three months' notice period) in bankruptcy, the *sukuk* holders have a rather safe position with regard to the periodic payments (during that period). In the meantime, the SPV can search for potential lessees who are willing to continue the *sukuk* transaction. The authority of the SPV for such action mainly depends on the terms and conditions of the *sukuk*.

627 Art. 58 (1) DBA. *See* Dutch Supreme Court 11 April 2008, *NJ* 2008, 222, para. 3.6.
628 Art. 58 (1) DBA. *See* Dutch Supreme Court 20 December 2013, *RvdW* 2014, 131, paras. 4.6.1 and 4.6.2.
629 Art. 182 DBA.
630 *See* Section 5.3.3.2 of Chapter 5.
631 Art. 7:226 DCC.
632 Art. 39 (1) DBA.
633 Dutch Supreme Court 19 April 2013, *NJ* 2013, 291, with case note by Verstijlen, para. 3.6.2.
634 Vriesendorp 2013, pp. 296-302.

Once the SPV or the bankruptcy trustee of the originator terminates the *ijarah* agreement on the basis of Article 39 DBA, the *ijarah* agreement will end after the three months' notice period. The SPV can sell and transfer the tangible property to a third party and use the proceeds to redeem the *sukuk*. The *sukuk* holders are exposed to the risk of depreciation in the value of the tangible property, which means that they could receive less than their principal amount if the tangible property has decreased in value. Although this consequence is not strictly required under Islamic finance law, it is in line with the *Shari'ah* perspective on the *sukuk al-ijarah* transaction, according to which the *sukuk* holders act as the economic owners of the underlying tangible property in the *sukuk al-ijarah* transaction. The SPV will not be able to oblige the bankruptcy trustee of the originator to offer to purchase the tangible property by exercising the unilateral obligation to offer under the promise of *wa'd*. Pursuant to the unilateral obligation to offer, the originator will be obliged to offer to purchase the tangible property only at the maturity date of the *sukuk*. Nonetheless, even if the originator has such obligation during the bankruptcy of the originator based on the contract with the unilateral obligation of the originator to offer to purchase the tangible property, the bankruptcy trustee of the originator can choose to breach the contract. In such case, the SPV has an ordinary, unsecured claim for payment of damages due to breach of contract.[635]

In Dutch case law the question is addressed whether a lessor is entitled to damages after cancellation (*beëindiging*) of a rental agreement in bankruptcy of its lessee. According to the Dutch Supreme Court the termination (*opzegging*) of a rental agreement on the basis of article 39 DBA is a regular termination of the rental agreement, which does not entitle the lessor to a claim for damages which it can enforce against the bankruptcy estate of the lessee, not even when a right to damages for the remaining lease periods is contractually stipulated.[636] The foregoing also applies to sale and leaseback transactions.[637] A contractual stipulation that provides the lessor the right to rescind (*ontbinden*) the rental agreement in case of bankruptcy of the lessee and a contractual stipulation that entitles the lessor to damages for the remaining lease periods in such case have, nonetheless, effect towards the bankruptcy estate of the lessee.[638] The question whether the SPV is

635 Art. 37a DBA.

636 Dutch Supreme Court 14 January 2011, *NJ* 2011, 114, with case note by Van Schilfgaarde, para. 3.5.2. Such contractual stipulation of a right to damages is valid under Dutch law, but it has no effect towards the bankruptcy estate of the lessee, *see* Dutch Supreme Court 15 November 2013, *RvdW* 2013, 1361, para. 3.3.3.

637 Dutch Supreme Court 22 November 2013, *RvdW* 2013, 1389, para. 3.4.

638 Dutch Supreme Court 13 May 2006, *NJ* 2005, 406, with case note by Van Schilfgaarde, paras. 3.4.1 and 3.4.4. A contractual right to rescind (*ontbinden*) the rental agreement may be obstructed in

entitled to damages after cancellation of the *ijarah* agreement in case of bankruptcy of the originator is, however, not relevant in the *sukuk al-ijarah* because it is uncertain whether a clause that entitles the SPV to damages (after contractual rescission (*contractuele ontbinding*) for example) is permissible from an Islamic finance law perspective. Based on the Islamic finance law rules on penalty clauses in a *murabaha* transaction, a *Shari'ah* supervisory board could take the view that such clause is only permissible if the amount is paid to a charity.[639] Hence, such clause may possibly not affect the position of the SPV and the *sukuk* holders.

6.3 Concluding Remarks

In this chapter I assessed the rights of the *sukuk* holders in the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah* under Dutch law. The ownership of the *sukuk* holders is not realised through the transfer of the right of ownership of the underlying properties in *sukuk* transactions to *sukuk* holders, but through a securitisation process called *tawreeq*: the properties are separated from the patrimony of the originator by way of transfer to a bankruptcy-remote SPV. The SPV can be incorporated as a Dutch foundation or as a Dutch BV under Dutch corporate law. The SPV issues *sukuk* that entitle their holders to the financial benefits of the underlying properties, pursuant to the terms and conditions of the *sukuk*. As a result, under Dutch law the economic ownership of the underlying properties is transferred to the *sukuk* holders, which has no proprietary effect.

In order to secure the position of the *sukuk* holders under Dutch property law, the *sukuk* holders can acquire security rights through a collective security arrangement. A second SPV can be incorporated as a security agent that acquires, administrates and enforces the security rights for the *sukuk* holders. The legal relationship between the security agent and the *sukuk* holders is, however, contractual. Consequently, the *sukuk* holders remain exposed to the risk of bankruptcy of the security agent because they are ordinary, unsecured creditors in the bankruptcy of the security agent. Alternatively, the *sukuk al-musharaka* can be structured through the issuance of Dutch depositary receipts for shares. The articles of association of the *musharaka* BV could attach rights to attend meetings to the depositary receipts. As a result, the

case of rental of built immovable property (*gebouwde onroerende zaken*) because in such case only a court can rescind the rental agreement, *see* Art. 7:231 (1) DCC. This is a mandatory provision for rental agreements from which parties cannot deviate to the detriment of the lessee and, consequently, conditions subsequent (*ontbindende voorwaarden*) in rental agreements of built immovable property are also void (*nietig*), *see* Art. 7:231 (3) DCC; Dutch Supreme Court 8 November 2002, *NJ* 2002, 623, para. 3.4.

639 *See* Section 5.2.3 of Chapter 5. *See also* Art. 6/4 AAOIFI SS 9.

sukuk holders acquire a statutory joint right of pledge on the shares of the *musharaka* BV by operation of law and are secured creditors in the bankruptcy of the SPV.

In the event of bankruptcy of the originator in *sukuk* transactions, the result of the securitisation process called *tawreeq* becomes clear: the underlying properties are separated from the patrimony of the originator and do not fall into its bankruptcy estate. In the *sukuk al-musharaka* the SPV holds shares in the *musharaka* BV. The bankruptcy of the originator does not directly affect the position of the SPV and the *sukuk* holders under Dutch law. It may, however, indirectly affect the position of the SPV and the *sukuk* holders by triggering the bankruptcy of the *musharaka* BV or affecting its *Shari'ah* compliance. In case of bankruptcy of the *musharaka* BV, the SPV as shareholder will most probably receive no payments and the *sukuk* holders will lose their investment: the *sukuk* holders bear the economic risks of the investment in the *musharaka* BV.

In the *sukuk al-murabaha* the claims for payment of the instalments are part of the patrimony of the SPV. In this study, I have assumed that the SPV will require security rights for the instalments. In such case, the SPV will have secured claims against the bankruptcy estate of the originator under Dutch law. The originator can, however, also contemplate the issuance of unsecured *sukuk*. In such case, the SPV will have no security rights for the instalments and it will have ordinary, unsecured claims against the bankruptcy estate of the originator under Dutch law. Hence, the *sukuk* holders bear the economic risks of the (non-) payment of the claims, which they may have secured with security rights.

In the *sukuk al-ijarah* the SPV is the owner of the underlying tangible property of the *sukuk* transaction. In case of bankruptcy of the originator, the SPV (lessor) and the bankruptcy trustee of the originator (lessee) can terminate the *ijarah* agreement with a three months' notice period under Dutch bankruptcy law. The SPV can sell and transfer the tangible property and use the proceeds to redeem the *sukuk*. The *sukuk* holders as the economic owners of the tangible property bear the risk of depreciation of its value: the SPV has an ordinary, unsecured claim for payment of damages against the bankruptcy estate of the originator in case of breach of contract by the bankruptcy trustee of the originator under the contract with the unilateral obligation to offer to purchase the tangible property.

After the assessment of the process of *tawreeq* under Dutch law, the following lessons are learned about the Islamic and the Dutch legal system. With regard to the Islamic legal system, the legal justification for the acceptance of *sukuk* is inconsistent with the classical doctrine of Islamic property law. In Chapter 2 I discussed that the right of ownership (*milk*) is restricted to corporeal objects (*ayn*) under Islamic property law. The rules of Islamic property

law do not apply to claims (*dayn*). The trade in claims (*bay' al-dayn*) results in a violation of the prohibition of *riba* and, therefore, claims can only be traded at face value. In this chapter I assessed the rights of the *sukuk* holders. The *sukuk* holders have only contractual rights to the SPV under Dutch law. The *sukuk* are debt claims and the *sukuk* holders trade in debt claims while trading their *sukuk* in secondary markets. From a strict classical approach to Islamic property law, the trade in *sukuk* leads to a violation of the prohibition on *riba*, more in particular the *bay' al-dayn*. Islamic scholars have, nonetheless, accepted these securities as *Shari'ah*-compliant by looking at the economic reality in financial markets: the securitisation process called *tawreeq* results in the transfer of the economic ownership of the underlying properties in *sukuk* transactions from the originator to the *sukuk* holders through the incorporation of an SPV to which the underlying properties are transferred and which holds them for the *sukuk* holders. As a result, the *sukuk* holders trade debt claims that entitle them to the economic ownership of underlying tangible properties while trading their *sukuk* in secondary markets.

Where, on the one hand, Islamic finance law has deviated from the classical doctrine of Islamic property law with regard to the trade in securities, which are in essence debt claims, the Islamic financial legal system still has built-in restrictions that are based on the classical doctrine of Islamic property law, on the other hand. It is possible to issue and trade *sukuk* in financial markets. It is, however, not possible to use *sukuk* as the underlying property for another *sukuk* issuance. In such case, the required connection with an underlying tangible property is disrupted and, consequently, the *sukuk* issued (using a pool of *sukuk* securities as its underlying properties) will not be tradable in secondary markets. This was reconfirmed by the AAOIFI in the AAOIFI Resolution of February 2008 on *sukuk*, as a disapproving reaction to the issuance of such tradable *sukuk* in practice. The only exception to the rule that securities cannot be used as the underlying properties for a *sukuk* transaction is the *sukuk al-musharaka* where *sukuk* are issued over the shares of a *musharaka* stock company. The *sukuk al-musharaka* is accepted by the AAOIFI as one of the 14 permissible *sukuk* structures. If, however, the *sukuk* securities of a *sukuk al-musharaka* are used as the underlying properties of a *sukuk* issuance, the required connection with underlying tangible properties is, once again, disrupted and such *sukuk* will not be tradable. As a result, the possibility for an abundant creation of debt claims is ceased.

With regard to the Dutch legal system, the following lesson can be learned. The closed system of Dutch property law does not allow the creation of proprietary rights in a way not provided by the law. It does not allow the division of the right of ownership into legal and beneficial ownership. Although Dutch legal practice felt the need to address a bundle of contractual rights

and obligations as 'economic ownership', this legal concept has no proprietary effect because that would not fit within the closed system of Dutch property law.

7 Legal Engineering of *Sukuk*: Summary and Conclusion

In this book I examined the possibilities to structure *sukuk* transactions under Dutch private law. The three *sukuk* transactions studied in this book, the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah*, can be structured under Dutch private law. The structuring of *sukuk* required legal engineering, that is, the creation of innovative and creative legal structures, under both Islamic and Dutch law. Whereas the legal engineering under Islamic law was mainly conducted by *Shari'ah* scholars who developed the product through a study of *fiqh*, I endeavoured in this research to develop the product in the Netherlands through legal engineering under Dutch law. In this final chapter I return with an answer to my research question as formulated in Chapter 1. My research question is:

> *How can* sukuk *transactions be structured under Dutch private law and what Islamic and Dutch legal issues arise when structuring* sukuk *under Dutch private law?*

In this chapter I start off with a summary of my findings and I answer the first part of my research question (Section 7.1): how can *sukuk* transactions be structured under Dutch private law? Next, I answer the second part of my research question (Section 7.2): what Islamic and Dutch legal issues arise when structuring *sukuk* under Dutch private law? Finally, I formulate suggestions as how to further develop the Islamic and Dutch legal issues addressed in this study (Section 7.3). I close this study with some general observations about the future of Islamic finance in the Netherlands.

7.1 Structuring *Sukuk* under Dutch Private Law

Summarising, the three *sukuk* structures assessed in this book can be structured under Dutch private law. There are no legislative amendments needed to structure *sukuk* under current Dutch private law. An understanding of Islamic law and finance (Section 7.1.1) and an understanding of *sukuk* (Section 7.1.2) were imperative in order to assess the Islamic finance rules for the *sukuk al-musharaka* (Section 7.1.3), the *sukuk al-murabaha* (Section 7.1.4) and the *sukuk al-ijarah* (Section 7.1.5) under Dutch private law.

7.1.1 Islamic Law and Finance

Sukuk are Islamic financial products that are based on Islamic law. *Shari'ah* scholars have studied the sources of Islamic law throughout ages to formulate rules for new arising challenges in society. As a result, they contributed to the development of Islamic jurisprudence (*fiqh*).[640] Due to differences in interpretation of the religious texts, there has been divergence in the practice of Islamic finance. Nonetheless, there is consensus on the two most important Islamic finance principles: (i) the prohibition of *riba;* and (ii) the avoidance of *gharar.*[641] First, according to the majority of the *Shari'ah* scholars all forms of interest are prohibited due to the prohibition of *riba*. In their view, profit should be generated through profit- and loss-sharing arrangements, where the financier shares in the profits and losses of an investment. Furthermore, as a result of the prohibition of *riba*, the presence of tangible properties is required in transactions: the trade in intangible properties (*bay' al-dayn*) resembles charging interest and is, thus, impermissible unless the intangible properties are traded at face value. Second, contractual uncertainty should be avoided as much as possible due to the prohibition of *gharar.* In addition, speculation (*qimar* or *mayseer*) in commercial transactions is also impermissible.

The two Islamic finance principles (*riba* and *gharar*) have determined the specific rules of Islamic private law.[642] The rules of Islamic private law, in turn, determine the contents of Islamic finance contracts. The contracts can be divided into three categories: equity-based, sale-based and lease-based. For the structuring of *sukuk*, I mainly focused on the prototype contract of each category: the *musharaka*, the *murabaha* and the *ijarah*. The *musharaka* is a partnership contract between the financier and the party requiring funding, which can also be structured through the incorporation of a stock company the shares of which are held by the financier and the party requiring funding.[643] A *murabaha* transaction consists of the sale of a tangible property by a third party to a financier, followed by its resale with a profit mark-up by the financier to the party requiring funding for the purchase of a tangible property.[644] The purchase price of the second sale is paid in instalments. The *ijarah* is a rental agreement relating to the lease of a tangible property.[645] These contracts are used to structure *sukuk*.

640 *See* Section 2.1 of Chapter 2.
641 *See* Section 2.2 of Chapter 2.
642 *See* Section 2.3 of Chapter 2.
643 *See* Section 3.1 of Chapter 3.
644 *See* Section 3.2 of Chapter 3.
645 *See* Section 3.3 of Chapter 3.

7.1.2 *Sukuk*

Sukuk are Islamic securities. Based on the principles of *riba* and *gharar* these securities should represent the ownership of the *sukuk* holders in the underlying properties of the *sukuk* transactions. Islamic property law does not require the *sukuk* holders to become the proprietary owners of the underlying properties. Economically, the *sukuk* holders should act as the owners of the properties. The ownership of the *sukuk* holders is realised through a securitisation process (*tawreeq*): the properties are separated from the patrimony of the originator by way of transfer to a bankruptcy-remote SPV, which issues *sukuk* securities that entitle their holders to the financial benefits of the underlying properties.[646] The *sukuk* certificates can be traded in secondary markets if the underlying properties are (deemed) tangible (as opposed to intangible properties). The three basic *sukuk* structures analysed in this book are: the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah*. On the basis of the Islamic finance rules for the underlying Islamic finance contracts and the Islamic finance rules for *sukuk*, I created a framework for the three *sukuk* structures.[647] This framework was taken into consideration when structuring *sukuk* under Dutch private law.

7.1.3 *Sukuk al-Musharaka* under Dutch Private Law

In the *sukuk al-musharaka* the originator can incorporate a Dutch BV. The BV will be a *Shari'ah*-compliant *musharaka*, which I refer to as a *musharaka* BV in this study.[648] The articles of association of the *musharaka* BV should stipulate in its objects that it will be a *Shari'ah*-compliant entity, which means that: (i) it cannot issue preference shares; (ii) its activities are limited to *halal* activites, with a list of prohibited immoral industries which are *haram* and in which it cannot engage; and (iii) its main activities must relate to tangible properties. In addition, it is necessary to include transfer restrictions in relation to the shares issued by the *musharaka* BV in its articles of association. This is the most distinctive feature of the *musharaka* BV: the stipulation of transfer restrictions in its articles of association, pursuant to which the transfer of its shares is excluded when the value of the tangible properties and the services of the *musharaka* BV is less than 30% of its total assets value based on its annual accounts of that year.

646 *See* Section 4.2 of Chapter 4.
647 *See* Section 4.3 of Chapter 4.
648 *See* Section 5.1 of Chapter 5.

The originator and an SPV hold the shares in the *musharaka* BV. The operations of the *musharaka* BV are mainly funded through the issuance of *sukuk* by the SPV. Pursuant to the terms and conditions of the *sukuk*, the SPV pays dividends received from the *musharaka* BV through to the *sukuk* holders. As a result, the *sukuk* holders can be considered to have the economic ownership (*economische eigendom*) of the shares of the *musharaka* BV.[649] Legally, the SPV is the owner of the shares of the *musharaka* BV which means that they are part of its patrimony (or bankruptcy estate in case of its bankruptcy) and its creditors have recourse on the shares.

In order to secure the economic ownership of the *sukuk* holders, a collective security arrangement can be created.[650] The originator incorporates a second SPV that will act as a security agent. Pursuant to a parallel debt clause, the security agent acquires an independent claim on the issuer which is parallel to the claims of the *sukuk* holders on the issuer. The security agent acquires security rights to secure the parallel claim. The legal relationship between the security agent and the *sukuk* holders is yet contractual. Hence, the *sukuk* holders remain exposed to the risk of bankruptcy of the security agent, which cannot be eliminated completely.

Alternatively, it is also possible to incorporate an administration office (*stichting administratiekantoor*) that acts as the SPV and issues depositary receipts for shares (*certificaten van aandelen*) to the *sukuk* holders.[651] The articles of association of the *musharaka* BV can attach rights to attend meetings (*vergaderrechten*) to the depositary receipts. Consequently, the *sukuk* holders acquire a statutory joint right of pledge (*wettelijk gezamenlijk pandrecht*) on the shares that the administration office holds by operation of law. As a result, the use of a collective security arrangement and the incorporation of a security agent are not required. The *sukuk* holders do not run a bankruptcy risk on the SPV because they are secured creditors (*separatisten*) in its bankruptcy.

A bankruptcy of the originator does not directly affect the *musharaka* BV, the SPV or the *sukuk* holders: the *musharaka* BV can continue its operations, the SPV remains one of its shareholders and the *musharaka* BV can continue paying dividends, if any, to the SPV which the SPV, subsequently, pays through to the *sukuk* holders.[652] The bankruptcy of the originator may, however, indirectly affect the position of the SPV and the *sukuk* holders by triggering the bankruptcy of the *musharaka* BV or by affecting its *Shari'ah* compliance (if the bankruptcy trustee of the originator wishes to sell and transfer the shares in the *musharaka* BV disregarding the transfer restrictions and a court honours

649 *See* Section 6.2.2.1 of Chapter 6.
650 *See* Section 6.2.2.2 of Chapter 6.
651 *See* Section 6.2.2.3 of Chapter 6.
652 See Section 6.2.3.1 of Chapter 6.

its request thereto). In case of bankruptcy of the *musharaka* BV, the SPV as its shareholder will most probably receive no payments and the *sukuk* holders will lose their investments: the *sukuk* holders as the economic owners bear the economic risks of the investments in the *musharaka* BV.

7.1.4 *Sukuk al-Murabaha* under Dutch Private Law

In the *sukuk al-murabaha* the originator is looking for *Shari'ah*-compliant funding to purchase a *halal* tangible property from a third-party seller. The originator incorporates an SPV. The third-party seller sells and transfers the tangible property to the SPV and the SPV, in a split second, sells and transfers the tangible property subject to the reservation of a security right (*overdracht onder voorbehoud van een zekerheidsrecht*) to the originator.[653] The originator acquires the tangible property encumbered with a security right from the outset, which means that the SPV does not run a risk towards other creditors of the originator who have acquired security rights on the tangible property in advance. The originator pays the purchase price plus a profit mark-up to the SPV in instalments. The contract of sale between the SPV and the originator qualifies as a purchase and sale of property on instalments (*koop en verkoop op afbetaling*). The mandatory provisions of book 7A DCC are not in conflict with Islamic law.

The SPV funds the purchase price through the issuance of *sukuk*. Pursuant to the terms and conditions of the *sukuk*, the *sukuk* holders are entitled to proceeds generated with the underlying property. The underlying property is the claim against the originator for payment of the purchase price. The SPV pays the purchase price it receives from the originator through to the *sukuk* holders. The *sukuk* holders have a bundle of contractual rights and obligations against the SPV in relation to the underlying property and are, therefore, deemed the economic owners of the underlying property.[654] In order to secure their contractual rights towards the SPV, a collective security arrangement can be created. However, the *sukuk* holders remain exposed to the risk of bankruptcy of the security agent that holds the security rights for them.

In case of bankruptcy of the originator, the SPV will have secured claims against the bankruptcy estate of the originator.[655] The SPV can exercise its security rights as secured creditor as if there were no bankruptcy. In the event of default on instalments by the bankruptcy trustee of the originator, the SPV can enforce its security rights. The rights of the SPV are, however, restricted

653 *See* Section 5.2 of Chapter 5.
654 *See* Section 6.2.2.1 of Chapter 6.
655 *See* Section 6.2.3.2 of Chapter 6.

in two ways. First, the bankruptcy trustee of the originator can request the supervisory judge (*rechter-commissaris*) to order a stay, a cooling-off period (*afkoelingsperiode*), of four months maximum. Second, the bankruptcy trustee of the originator can impose the SPV with a reasonable period within which it has to exercise its security rights. If the SPV fails to exercise its security rights within such reasonable period, the bankruptcy trustee of the originator may sell the tangible property himself and pay the proceeds to the SPV taking into account his rank, but after deduction of the bankruptcy costs (*faillissementskosten*).

7.1.5 *Sukuk al-Ijarah* under Dutch Private Law

In the *sukuk al-ijarah* the originator sells and leases back a *halal* tangible property to and from the SPV.[656] The transfer of the tangible property from the originator to the SPV as part of the sale and leaseback in the *sukuk al-ijarah* is not invalidated by Article 3:84 (3) DCC. The originator and the SPV intend an 'actual transfer' (*'werkelijke overdracht'*) of the tangible property to the SPV because the right of ownership of the SPV is not proprietary limited (to a right of recourse on the tangible property). The purpose of the originator and the SPV is to conclude a *Shari'ah*-compliant transaction. Under Islamic finance law, the SPV must become the owner of the tangible property and it is not possible to condition the right of ownership of the SPV upon an event (such as an event of default in payments) or to limit its right of ownership to a right of recourse on the tangible property.

The *ijarah* agreement, pursuant to which the tangible property is leased back, qualifies as a rental agreement under Dutch contract law. The originator and the SPV also enter into a contract, pursuant to which the originator has the unilateral obligation to offer to purchase the tangible property (*aanbiedingsplicht*) from the SPV at the maturity date of the *sukuk*. The SPV is not obliged to accept the offer and may, at its discretion, decide to sell and transfer the property to a third party. The (combination of the) rental agreement (with the contract with the unilateral obligation to offer) does not qualify as a hire purchase or as an agreement with the same essence as hire purchase because the rental agreement (and the contract with the unilateral obligation to offer) do(es) not contain an obligation to transfer the right of ownership of the tangible property to the originator. Thus, the mandatory provisions of book 7A DCC and of the IHPIPA do not have to be observed.

The SPV issues *sukuk* and uses the *sukuk* proceeds to pay the purchase price of the tangible property to the originator. The lease payments paid from

656 *See* Section 5.3 of Chapter 5.

the originator to the SPV are paid through to the *sukuk* holders. The *sukuk* holders are deemed the economic owners of the underlying tangible property of the *sukuk* transaction because they are entitled to the financial benefits of the underlying tangible property based on the terms and conditions of the *sukuk*. They have contractual rights and obligations against the SPV. In order to secure their contractual claims, a collective security arrangement can be created.[657] The bankruptcy risk to which the *sukuk* holders are exposed is not completely eliminated in such case because it transfers from the SPV that is the issuer to the SPV that is the security agent.

The bankruptcy of the originator does not affect the SPV because the underlying tangible property of the *sukuk al-ijarah* transaction does not fall into the bankruptcy estate of the originator.[658] The SPV is the owner of the tangible property. The SPV and the bankruptcy trustee of the originator have the right to terminate (*opzeggen*) the *ijarah* agreement with a three months' notice period. The claim of the SPV for the lease payments (for the three months) in bankruptcy are estate claims (*boedelschulden*). The *ijarah* agreement ends after the three months' notice period. The SPV can then sell and transfer the tangible property to a third party free of the *ijarah* agreement. The *sukuk* holders as the economic owners of the tangible property bear the economic risks of the tangible property in such case, *e.g.* the risk of depreciation of its value. The bankruptcy trustee of the originator may breach the contract with the unilateral obligation of the originator to offer to purchase the tangible property, leaving the SPV behind with an ordinary, unsecured claim for damages on the basis of breach of contract on the bankruptcy estate of the originator.

7.2 Islamic and Dutch Legal Issues regarding the Structuring of *Sukuk* under Dutch Law

7.2.1 Islamic Legal Issues regarding the Structuring of *Sukuk* under Dutch Law

The structuring of *sukuk* under Dutch law touched upon three Islamic legal issues. First, the centre of gravity of the prohibition of *riba* was revealed. Second, the absolute and unconditional character of the right of ownership of tangible properties was explored. Third, the position of securities within the classical doctrine of Islamic property law was addressed.

First, I illustrated the two pillars on which the prohibition of *riba* stands when structuring *sukuk* under Dutch private law in this book: (i) the concept

657 *See* Sections 6.2.2.1 and 6.2.2.2 of Chapter 6.
658 *See* Section 6.2.3.3 of Chapter 6.

of profit-and-loss-sharing; and (ii) the requirement of tangible properties in Islamic finance transactions. Islamic finance law is based on the understanding that all forms of interest are prohibited. As a result, the financier should share in the profits and losses of his investment. Furthermore, profit-generating transactions are structured within Islamic finance so that profit is made instead of interest. The decisive distinction between the permitted profit and the prohibited interest relates to the trade in tangible properties, as opposed to the trade in intangible properties which resembles charging interest: the payment of money for the use of money.

The structuring of the *sukuk al-musharaka* under Dutch law illustrates best what the essence of the prohibition of *riba* entails. The rules for a *musharaka* BV under Islamic and Dutch law are mainly similar. Where these rules deviate, the differences can be ascribed to the prohibition of *riba*. Islamic law does not allow the disruption of equal profit- and loss-sharing between the shareholders through the issuance of preference shares by the *musharaka* BV. This stresses the significance of profit- and loss-sharing under Islamic law. Furthermore, the requirement that the main activities of the *musharaka* BV pertain to tangible properties and that its shares cannot be traded when the value of its tangible properties and services is less than 30% of its total assets value stresses the importance of the trade in tangible properties. In the *sukuk al-ijarah* the underlying property should be a tangible property, also stressing the importance of the trade in tangible properties under Islamic finance law. The *sukuk al-murabaha*, on the other hand, are not tradable because the underlying properties of the *sukuk al-murabaha* are intangible properties, *i.e.* claims.

Second, the right of ownership has an absolute character under Islamic property law. It is not possible to proprietarily condition the right of ownership. Islamic property law does not acknowledge the concept of security ownership (*zekerheidseigendom*). The transfer of a tangible property with the reservation of ownership (*eigendomsvoorbehoud*) is not acknowledged under Islamic property law, unlike Dutch property law. The transfer of fiduciary security ownership (*fiduciaire zekerheidseigendom*) is also not acknowledged under Islamic property law, which is also the case under Dutch law. Under Islamic law a transferor can, however, transfer the right of ownership of a tangible property subject to the reservation of a security right in order to create a valid security right on a tangible property (a so-called fiduciary pledge under Islamic finance law) because in such case the right of ownership of the owner is not contractually conditioned upon an event. The owner of a tangible property has its complete right of ownership and a security right holder acquires only a security right.

Even though Islamic law has a strict approach towards the right of ownership, a form of 'derivative' economic ownership has been accepted in financial markets. This brings me to the third and final issue under Islamic law. The

acceptance of the trade in shares and *sukuk* with the argument that the shareholders and the *sukuk* holders are the economic owners of the tangible properties of the stock company respectively the underlying tangible properties of the *sukuk* transactions has marked a milestone in the development of Islamic finance law. According to the classical approach under Islamic property law, the trade in securities would have been practically impossible due to the rules for *bay' al-dayn*, which allow the trade in intangible properties only at face value. As a result, the trade of securities, which in essence are debt claims, in financial markets would have been disqualified. With regard to financial markets, however, *Shari'ah* scholars accepted an approach where they considered the economic substance of the transactions over their legal form. They looked at the economic reality where shareholders and *sukuk* holders can be regarded as the economic owners of the assets of a stock company respectively the underlying properties in *sukuk* transactions.

The Islamic finance literature has not paid much attention to the form of the *sukuk* securities so far. This point has also not been dealt with in this book. The developments in financial markets with regard to the dematerialisation of securities, that is, in most jurisdictions securities are not traded in a paper form anymore but they are held by intermediaries that provide the securities holders only with book entries, raise the question how this fits into the classical doctrine of Islamic property law. The study in this book illustrates that *sukuk* securities are not regarded as tangible properties themselves but are deemed evidence of 'economic ownership rights' in underlying tangible properties of *sukuk* transactions. What follows from the debate in Islamic finance literature on the ownership of *sukuk* holders in the underlying tangible properties of *sukuk* transactions is the question whether for Islamic purposes such ownership is also transferred to *sukuk* holders if the *sukuk* securities are not issued in paper form and the *sukuk* holders have only book entries. This question was not dealt with in this book, but it may provide inspiration for further research on the topic.

7.2.2 Dutch Legal Issues regarding the Structuring of *Sukuk* under Dutch Law

Structuring *sukuk* under Dutch private law brought the following three Dutch legal issues into light. First, Dutch private law allows for the structuring of Islamic finance transactions. Second, recent amendments in Dutch corporate law made the incorporation of a *musharaka* BV possible. Third, the concept of economic ownership under Dutch law resembles the required ownership of *sukuk* holders in *sukuk* transactions under Islamic law.

First, Dutch private law allows for the structuring of Islamic finance transactions. The study in this book clarifies that Dutch private law is sufficiently flexible for contracting parties to structure *sukuk* transactions such as the *sukuk*

al-musharaka, the *sukuk al-murabaha* and the *sukuk al-ijarah*. While assessing the Islamic finance rules for these three *sukuk* transactions under Dutch law, I also assessed the Islamic finance rules for Islamic finance contracts such as the *musharaka*, the *murabaha* and the *ijarah* under Dutch private law. Hence, this study also shows that Dutch private law allows the conclusion of Islamic finance contracts such as the *musharaka*, the *murabaha* and the *ijarah*.

Second, recent legislative amendments with regard to the Flex BV law aimed to provide more flexibility for parties as to the internal organisation of a BV. As a result of these legislative amendments, one of the Islamic finance requirements for the incorporation of a *musharaka* BV can be met under Dutch corporate law: the trading of the shares of a *musharaka* BV can be excluded at times when the value of the tangible properties and the services of the *musharaka* BV is less than 30% of its total assets value. With the entry into force of the Flex BV law it is possible to temporarily exclude the transfer of the shares of a BV. Before the introduction of the Flex BV law, this was not possible under Dutch law.

Third, in this study the contractual rights of the *sukuk* holders were qualified as economic ownership under Dutch law. Remarkably, the concept of economic ownership under Dutch law resembles the ownership required for the *sukuk* holders under Islamic finance law. Under both Islamic and Dutch law a separation of the right of ownership into legal and beneficial ownership is not possible. Strictly speaking, the *sukuk* holders do not acquire the proprietary ownership of the underlying properties in *sukuk* transactions under (classical) Islamic property law, but they are deemed the economic owners of those properties. Under Dutch law economic ownership is not a form of ownership with any proprietary effects either. It refers to a bundle of contractual rights and obligations in relation to a property. The property remains, however, part of the patrimony of its legal owner (SPV). Consequently, the creditors of the legal owner (SPV) have recourse on the property and the property falls into its bankruptcy estate.

7.3 The Future of Dutch and Islamic Law and Finance

7.3.1 Proposals for a Different Approach to *Riba* in Islamic Jurisprudence (*Fiqh*)

The cornerstone principle of Islamic finance is the prohibition of *riba*. The prohibition of *riba* is interpreted by the majority of *Shari'ah* scholars as a prohibition on interest and, therefore, the main focus within Islamic finance has been on a complete ban on interest. One may, however, wonder to what extent such complete ban is upheld and justified within current day Islamic finance. In this study I illustrated how profit is generated and paid to *sukuk*

holders through the use of alternative structures. Such structures are often complicated and raise transaction costs because additional structuring leads to additional fees for lawyers, bankers and other professional advisers of the parties to the *sukuk* transactions. The economic result of all three transactions discussed in this book is, nonetheless, that a borrower (originator) borrows money from investors in financial markets (*sukuk* holders) and it pays a return for the use of that money to those investors.

Furthermore, the strict ban on interest has resulted in a forced deviation from the classical approach to the concept of ownership under Islamic property law. By accepting the ownership of shareholders and *sukuk* holders in the assets of a stock company respectively the underlying properties in *sukuk* transactions the trade in these securities remained acceptable under Islamic finance law. Nevertheless, from a legal perspective, the securities holders are trading in intangible properties (debt claims on the stock company or the SPV) while trading their securities in secondary markets.

At the same time, this study illustrated that there is a difference between interest-bearing loans and Islamic finance products. The required link between tradable *sukuk* issued in financial markets and the underlying tangible properties of the relevant *sukuk* transaction limits the possibilities to pile debt on debt. The Islamic finance industry has been able to avoid the unchecked and excessive accumulation of debts. Therefore, it may even provide inspiration to answer the question of how to move forward after the financial crisis. The essence of the prohibition of *riba* may be in the creation of a stable financial system. If that is the case, it becomes interesting to examine whether the prohibition of *riba* could be implemented in the regulatory framework of a jurisdiction to regulate the financial markets instead of prohibiting interest. The implementation of the essence of the prohibition of *riba* in the regulatory framework of a jurisdiction may, for example, result in restrictions on financial products that are highly leveraged, *i.e.* financial products that represent or are purchased with an excessive amount of debt.

In this view, the Islamic finance industry would look beyond a strict prohibition of interest and focus on the true meaning of and the rationale for the prohibition of *riba*. If the essence of the prohibition of *riba* lies in the creation of a stable financial system and this is implemented in the regulatory framework of a jurisdiction, *Shari'ah* scholars may even consider allowing the payment and receipt of interest. As a result, the creation of complicated financial and legal structures with additional transaction costs would not be needed anymore. These developments may be less far from the current Islamic finance industry than one might assume. In Malaysia Islamic finance principles have already been implemented in the regulatory framework to some extent, while the prohibition of interest has a less broad scope than in Middle Eastern countries, which appears from the acceptance of the trade in intangible properties

(*bay' al-dayn*). As a leader in the world of Islamic finance, Malaysia may set an example for the future of Islamic finance. I do acknowledge that this requires, first and foremost, a different form of interpretation and *ijtihad* by Islamic scholars. Moreover, this approach also requires further examination from a legal perspective, for which this book can give only a glimpse.

7.3.2 Proposals for Future Legislation under Dutch Law

The structuring of *sukuk* under Dutch law requires no legislative amendments. Current Dutch private law allows for the structuring of the *sukuk al-musharaka*, the *sukuk al-murabaha* and the *sukuk al-ijarah*. In order to even better facilitate the structuring of *sukuk* transactions under Dutch law the Dutch legislature may, however, consider the following legislative amendment with regard to the economic ownership of *sukuk* holders under Dutch law. *Sukuk* holders are exposed to the risk of bankruptcy of the legal owner (SPV) of the underlying property in *sukuk* transactions under current Dutch law. The statutory joint right of pledge of Article 3:259 DCC perfectly answers to the required proprietary protection of the rights of economic owners (*sukuk* holders) in the *sukuk al-musharaka* under Dutch property law. The scope of Article 3:259 DCC is, however, restricted to the issuance of depositary receipts for securities, more specifically shares and debt claims. The Dutch legislature may consider the extension of the scope of Article 3:259 DCC to depositary receipts for tangible properties (*certificering van zaken*) and to depositary receipts for patrimonial rights (*certificering van vermogensrechten*). As a result, the structuring of the *sukuk al-ijarah* and the *sukuk al-murabaha* becomes more attractive under Dutch law because the *sukuk* holders acquire a statutory joint right of pledge by operation of law and are secured creditors in the bankruptcy of the legal owner (SPV) of the underlying properties in *sukuk* transactions.

7.3.3 Future for Islamic Finance in the Netherlands

This book illustrated that the three *sukuk* transactions discussed in this study can be structured under Dutch private law. When structuring *sukuk* under Dutch law, it became clear that the Islamic finance contracts discussed in this book can also be structured under Dutch private law. The conclusion of this study is, thus, broader than *sukuk* transactions alone: it relates to the position of Islamic finance in the Netherlands. On the one hand, the *Shari'ah* is generally frowned upon in the Netherlands. This study demonstrated that the Islamic rules for Islamic finance transactions are not in conflict with Dutch law. The essence of some of the Islamic finance rules even showed similarities with the rationale of certain rules under Dutch law. Hence, introducing

Islamic finance in the Netherlands may prove to be less peculiar and less exotic than some may have thought.

Dutch law has, on the other hand, been disregarded in Islamic finance practice. Islamic finance transactions are often governed by English law. This study illustrated the compatibility of Dutch private law with Islamic private law. The legal framework is in place to structure *sukuk* transactions under Dutch law. It is now up to Dutch finance practice to commence Islamic finance transactions in the Netherlands.

Glossary of Islamic Finance Terms

aqd	A contract under Islamic contract law. A contract is concluded through an offer (*idjab*) and an acceptance (*qaboel*) under Islamic contract law.
ayn	*Ayn* refers to a tangible property: an existing thing that can be subject to human control and that can be determined.
bay'	The contract of sale under Islamic contract law.
bay' al-dayn	The trade in claims. See *riba*.
bay' al-inah	See *murabaha*.
dayn	*Dayn* literally means 'debt' and it refers to an obligation (either to perform an act or to pay money).
fatwa	A legal advice or legal opinion issued by an Islamic scholar in response to a question posed by an individual. Contrary to a binding judgment of a judge (*qadi*), a *fatwa* issued by an Islamic scholar is a non-binding legal opinion.
fiqh	*Fiqh* refers to Islamic jurisprudence. It is often divided into *usul al-fiqh* and *furu al-fiqh*.
furu al-fiqh	*Furu al-fiqh* is a form of Islamic jurisprudence. It refers to substantive Islamic law.
genizah document	*Genizah* documents are documents that were stored in Middle Eastern mosques and synagogues because the word 'God' was written either in Arabic or Hebrew. Therefore, the merchants of the Middle Ages were reluctant to destroy such documents.
gharar	*Gharar* refers to contractual uncertainty. According to Islamic finance law *gharar* should be avoided as much as possible in Islamic finance contracts. As a result of the principle of *gharar, qimar* (gambling) and *mayseer* (speculation) are also discouraged.
hadith	See *sunnah*.
halal	*Halal* means legal or permitted under Islamic law.
haram	*Haram* means illegal or not permitted under Islamic law.
'ibadat	*'Ibadat* refers to the rules in Islamic law that regulate the relationship between humans and God.
idjab	See *aqd*.
ijarah	The contract of *ijarah* is a lease contract, pursuant to which the owner of a property (lessor) provides its right of use (called *manfaa*) to another party (lessee) for an agreed period at an agreed price. It is often compared to an operational lease.
ijarah muntahia bittamleek	See *ijarah wa-iqtina*.
ijarah wa-iqtina	*Ijarah wa-iqtina* is a leasing arrangement that consists of an *ijarah* contract and an additional binding promise of the lessor to the lessee to offer to transfer the ownership of the property to the lessee at the end of the lease period. The *ijarah wa-iqtina* is often compared to a financial lease. It is also referred to as *ijarah muntahia bittamleek*.

ijma'	*Ijma'* refers to the consensus of the majority of Islamic scholars on a specific matter. Although preferably *ijma'* refers to the consensus of the entire community (consensus of *umma*), practicality and pragmatism lead to the acceptance of *ijma* as the consensus of the learned in the Islamic community (consensus of *ulema*). *Ijma'* is a source of Islamic law.
ijtihad	*Ijtihad* refers to the use of one's logical reasoning and common sense to deduce the true meaning of a rule in Islamic law. *Ijtihad* is a source of Islamic law. An Islamic scholar who practices *ijtihad* is called *mujtahid*.
istisna'	*istisna'* is a future sale contract, pursuant to which the seller of a property will manufacture and deliver a specified property to the buyer at a future date.
madhahib	Schools of Islamic law.
mal	Property under Islamic property law. The concept of property is limited to *ayn* (tangible property) under Islamic property law.
malik	The owner of the right of ownership of a property under Islamic property law.
manfaa	See *ijarah*.
mayseer	Speculation. See *gharar*.
milk	The right of ownership under Islamic property law.
mu'amalat	*Mu'amalat* refers to the rules in Islamic law that regulate the relationship between humans and humans.
mudarabah	A partnership contract whereby one partner contributes capital to the partnership (called the *rab al-maal*), while another partner has the sole right to the management of the partnership (called the *mudarib*). The *mudarabah* is often compared to a limited partnership with a silent partner. The *mudarabah* is also referred to as *qirad* or *muqaradah*.
mudarib	See *mudarabah*.
mugharasa	See *musharaka*.
mujtahid	See *ijtihad*.
muqallid	See *taqlid*.
muqaradah	See *mudarabah*.
maqasad al-Shari'ah	The objects of Islamic law.
murabaha	The contract of *murabaha* was traditionally a contract of sale, pursuant to which the seller of a property disclosed the cost price of the property and the profit mark-up to the buyer. Within Islamic finance it is used as a transaction whereby a party sells a property to a financier, followed by a resale of that property by the financier to the ultimate buyer who pays the cost price plus a profit mark-up to the financier in instalments. The *murabaha* can be used for asset finance purposes only. The seller of the property and the ultimate buyer of the property cannot be the same party because otherwise there is a sale and buy-back which results in the forbidden *bay' al-inah*.
musaqa	See *musharaka*.
musharaka	A partnership contract whereby each partner (called *sharik*) contributes capital to the partnership and has a right to its management. The *musharaka* contract is often compared to a joint venture. The *muzara'a*, *musaqa*, and *mugharasa* are forms of partnership contracts that can be used for the agricultural sector.
muzara'a	See *musharaka*.
qaboel	See *aqd*.

qadi	See *fatwa*.
qimar	Gambling. See *gharar*.
qirad	See *mudarabah*.
qiyas	*Qiyas* refers to reasoning based on analogy and it is a source of Islamic law.
Qur'an	The holy book of the religion Islam. It is a source of Islamic law.
rab al-maal	See *mudarabah*.
riba	According to the majority of the contemporary Islamic scholars *riba* refers to all forms of interest. It is prohibited under Islamic finance law. *Riba* is often divided into three different forms: the *riba al-jahiliyya*, the *riba al-fadl* and the *riba al-nasi'a*. As a result of the prohibition of *riba*, the trade in claims (*bay al-dayn*) is also prohibited.
riba al-fadl	*Riba al-fadl* refers to an excess of one of the counter values in an on-the-spot transaction. This form of *riba* is also referred to as *riba* by way of excess.
riba al-jahiliyya	*Riba al-jahiliyya* refers to *riba* that was charged during the pre-Islamic period in Arabia. When a creditor could not repay his debts at maturity, the debt was doubled and redoubled. This resulted in inhuman practices.
riba al-nasi'a	*Riba al-nasi'a*, also known as *riba* by way of deferment, refers to *riba* charged when delivery of one of the counter values is delayed in a transaction. This form of *riba* is often compared with conventional interest.
salam	The contract of *salam* is a future sale contract, pursuant to which the seller of a property undertakes to transfer the right of ownership of that property to the buyer at a future date in consideration of full payment at the moment of the conclusion of the contract of *salam*.
Shari'ah	*Shari'ah* is Islamic law. The word '*Shari'ah*' means 'the way' or 'the path to the water source'. Islamic law within the meaning of Islamic finance is not codified law, but it refers to a set of rules derived from religious texts.
sharik	See *musharaka*.
Shi'a	There are two main divisions in Islam: *Sunni* and *Shi'a*. Three *Shi'a* schools of Islamic law are: *Ithna 'Ashari, Isma'ili* and *Zaydi*.
shirkah	*Shirkah* means 'sharing' and it refers to legal concepts where rights and/or obligations are shared between parties. It can be divided into *shirkat al-aqd* (sharing by contract) and *shirkat al-milk* (sharing in ownership).
shirkat al-amal	See *shirkat al-aqd*.
shirkat al-aqd	*Shirkat al-aqd* literally means 'sharing by contract'. It refers to a partnership in business effected through a contract. The *shirkat al-aqd* is further divided into three categories: the *shirkat al-wujooh* (partnership based on good reputation in the market), the *shirkat al-amal* (partnership based on services) and the *shirkat al-inan* (partnership based on capital investment). The *musharaka* is a form of *shirkat al-inan*.
shirkat al-inan	See *shirkat al-aqd*.
shirkat al-milk	*Shirkat al-milk* literally means 'sharing in ownership'. It refers to joint ownership of property by at least two persons.
shirkat al-wujooh	See *shirkat al-aqd*.

sukuk	*Sukuk* are Islamic securities which are regarded as a *Shari'ah*-compliant alternative to conventional bonds. The Arabic word '*sukuk*' is the plural of the word '*sakk*' which means 'certificate' or 'order of payment'. The most distinctive feature of *sukuk* is that they should represent the 'economic ownership' of the *sukuk* holders in the underlying property that the *sukuk* securities represent.
sukuk al-ijarah	A *sukuk* structure that is based on the contract of *ijarah*. In the *sukuk al-ijarah* structure an originator raises funds by incorporating an SPV, entering into a sale and leaseback with that SPV and requiring the SPV to issue *sukuk* to *sukuk* holders to raise funds for the purchase of the property that the originator sells to and leases back from the SPV.
sukuk al-murabaha	A *sukuk* structure that is based on the contract of *murabaha*. In the *sukuk al-murabaha* an originator raises funds to purchase a property. It incorporates an SPV. The SPV issues *sukuk* and uses the proceeds to purchase the property from a third-party seller. Next, the SPV sells the property to the originator in consideration for payment in instalments.
sukuk al-musharaka	A *sukuk* structure that is based on the contract of *musharaka*. An originator incorporates an SPV and it enters into a *musharaka* contract with that SPV. The SPV issues *sukuk* to fund its capital contribution to the *musharaka*.
sunnah	*Sunnah* refers to the practices of the Prophet Muhammad. The concrete details of *sunnah* are described in *hadith*. *Hadith* is the narrative of a particular occurrence, while *sunnah* is the rule deduced from the practice of the Prophet Muhammad. It is a source of Islamic law.
Sunni	There are two main divisions in Islam: *Sunni* and *Shi'a*. Four *Sunni* schools of Islamic law are: *Hanafi', Maliki, Shafi'i* and *Hanbali*.
taqlid	*Taqlid* refers to the acceptance of an Islamic rule on the authority of other Islamic scholars. The Islamic scholar who practices *taqlid* is called a *muqallid*.
tawarruq	In a *tawarruq* contract the party who is in need of funding purchases a tangible property from a financier on a deferred payment basis. The price is often higher than the real value of the tangible property. Next, the party who is in need of funding sells the tangible property to a third party for a lower price (the real value of the tangible property) and this purchase price provides him money instantly. It is also referred to as reverse *murabaha* or commodity *murabaha*. In the literature and practice, the contract of *murabaha* and the contract of *tawarruq* are often used interchangeably. However, *tawarruq* is not permitted under Islamic law.
tawreeq	A securitisation process whereby the 'economic ownership' of the underlying property in a *sukuk* transaction is transferred to the *sukuk* holders. The ownership of the property is divided into units of equal value and *sukuk* are issued as per their value.
ulema	See *ijma'*.
umma	See *ijma'*.
wa'd	A *wa'd* is a binding promise. From an Islamic law perspective, the promise of *wa'd* is binding on the promisor and it is legally enforceable in court. It has the same legal effect as a contract with a unilateral obligation in many jurisdictions.

wakalah	The *wakalah* contract is a contract of agency, which is often compared to the contract of *mudarabah*. The difference with the contract of *mudarabah* is that the agent in a *wakalah* contract is entitled to a fixed fee instead of a percentage of the profit.
waqf	The *waqf* is a legal concept whereby the ownership of a property is held by a party, while its management or financial benefits are transferred to another party. It is used for religious and charitable purposes.
usul al-fiqh	*Usul al-fiqh* is a form of Islamic jurisprudence. It is procedural Islamic law. *Usul al-fiqh* refers to the main sources of Islamic law.
zakat	A form of alms.

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About the Author

Omar Salah was born on 14 March 1985 in Kabul, Afghanistan as the third child to an Afghan general and an Afghan authoress. In 1993, he moved with his family to the Netherlands. After attending a first year of Dutch language classes at the St. Hubertus School, he finished his elementary education in 1999 at the same school. In 2005, he obtained his A levels (*VWO*) at 2College West (formerly known as Paulus Lyceum). In 2008, he obtained an LLB in Dutch Law (*with distinction*) and an LLB in International and European Law (*with distinction*) at Tilburg Law School, Tilburg University. In 2009, Salah obtained an LLM in Dutch Law (*cum laude*) at Tilburg Law School, Tilburg University. He attended a Summer University at the North-West University in South Africa in 2008 and a Summer University at the University of California, Berkeley in the United States in 2009.

In 2009, Salah started working as a PhD Candidate at the Private Law Department of Tilburg University while being affiliated with De Brauw Blackstone Westbroek. At Tilburg University, he worked on his dissertation on Islamic finance under Dutch private law. Salah also gave lectures on Dutch Property Law (LLB course) and Corporate Finance Law (LLM course). In 2011, Salah joined De Brauw Blackstone Westbroek as a lawyer (*advocaat*) where he worked with the Litigation and Arbitration practice group (Corporate Litigation, Supreme Court Litigation, and Insolvency) and with the Finance practice group, while continuing writing his dissertation at Tilburg University. Salah has been a (guest) lecturer at Tilburg University, Leiden University, Maastricht University, and the University of Amsterdam in the Netherlands. Salah has also been a visiting researcher and guest lecturer at the University of Oxford, the University of Melbourne and La Trobe University. In 2010, he was on a secondment at the Middle East & Islamic Finance Practice Group of law firm King & Spalding in London. Salah has published extensively on Islamic finance and is a frequent speaker at international conferences.

Salah was granted a Grotius Scholarship by Grotius Academie in 2009. His master's thesis was awarded the Harry Honée Master's Thesis Award 2008/2009 as the best thesis on Dutch corporate law by Stichting Harry Honée Fonds. His master's thesis was also awarded the RIMO Master's Thesis Award 2009/2010 as the best thesis on the law of Islam and the Middle East by Vereniging RIMO. He was granted a PhD Overseas Travel Fellowship for the

Australia-Netherlands Research Collaboration in 2010. In 2012, Salah won the Young Professional Award 2012 of ARIA Students.